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Jonathan Hay and Nirmaljit Paul

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Washington, D.C.
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When this paper was written, Jonathan Hay was a field Consultant in the Financial Policy and Projections Division, Risk Management and Financial Policy Department of the World Bank. Nirmaljit Paul is a Financial Policy Analyst in the same department.

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PREFACE

The debt crisis, since it burst upon the world’s attention in the summer of 1982, has generated a great deal of discussion and debate, and it has spawned a lot of writing. Most attention has been focussed on schemes to solve the crisis, justifications for various forms of debt relief and reduction, and defenses of creditor positions. This has been an interesting and instructive series of exchanges, and we have witnessed substantial progress on a number of fronts in the debt crisis. One absolutely critical area for the resolution of external commercial debt problems has been the substantial progress made in clarifying and refining the tax and regulatory environments for creditor banks in their own countries. For a variety of reasons, due both to the highly technical nature of the subject matter and to the discrete bureaucratic processes that govern such regulations, these developments have received much less attention in the public dialogue on the debt crisis.

Perhaps this is as it should be, but it is also important to recognize and record the substantial progress that has been made in the evolution of tax and regulatory treatment of sovereign debt, and in particular non-performing, rescheduled, and/or restructured sovereign debt. This has done a great deal to facilitate the debt reduction operations that have occurred and to help define the parameters under which future operations will be structured. The regulators have been keenly aware of the import of their rules and guidelines for the operations of financial institutions in this area and concerned to offer judicious and reasonable support for innovation while protecting basic prudential principles and avoiding “give-aways” to banks, who were, after all, responsible for their lending portfolios.

Regulations Governing Sovereign Lending: Sovereign lending had received little regulatory attention prior to the 1980’s. It was a relatively new phenomenon and initially it had involved only governments with the best credit ratings. That changed in the later 1970’s as petrodollars were recycled to many developing country governments with relatively weaker credit standing. Despite Walter Wriston’s (then CEO of Citibank) assurances that “sovereign government don’t go bankrupt,” many of them defaulted on their scheduled payments. Some were ultimately unable to fully meet their obligations to commercial banks, leading to a variety of debt reduction operations under the auspices of the Brady Initiative.

The sovereign credits in question were governed by applicable commercial law in one or several of the creditor banks’ jurisdictions, as agreed in the individual loan documents. Often countries’ debts were complex mixes of loans and syndicated credits, falling under different jurisdictions. Usual remedies against default in private cases were unlikely to be effective against sovereigns, and since potential gains to any single claimant would often have to have been shared, there was little incentive for an individual creditor to follow such remedies. In addition, many debtors moved to protect what assets they had that might have been subject to seizure. In the event, such remedies were rarely attempted.
No established procedures existed for treating sovereign default (or inability to make scheduled payments) when Mexico informed its commercial creditors in August, 1982 that it could no longer service its debt. The isolated individual cases of commercial debt servicing problems that had occurred theretofore had been resolved through negotiations. Procedures had been established for rescheduling official debt through the Paris Club, where countries had to demonstrate that they were trying to institute appropriate economic reforms with the assistance and financial support of the IMF and the World Bank. Both of these precedents served as models for developing procedures for treating debt servicing problems on commercial debt.

**Regulator Issues and Concerted Lending:** Committees of major creditor banks were formed to negotiate with the debtors (often representing a body of several hundred individual creditor banks). The International Financial Institutions, (IMF and World Bank) were requested to help countries design adequate stabilization and adjustment programs that would assure improved country prospects in exchange for some debt relief (initially rescheduling). And national regulatory agencies urged all parties to reach some kind of nominally voluntary agreement that avoided explicit recognition of default. The regulatory agencies had a particular interest in this result, for the exposure of many major international banks to troubled developing country debtors exceeded the capital base of these banks -- by a factor of more than two in some cases. Had these banks been obliged to write down that debt as non-performing, they themselves would have become insolvent, with unthinkable repercussions on the international financial system. At the time, it was in everyone’s interest to find solutions that bought time and avoided precipitous actions. Debtors had to adjust, but couldn’t do so rapidly, and creditors needed time to strengthen their balance sheets in order to eventually absorb the losses implicit in their developing country exposure.

Lacking any formal bankruptcy procedure of law for sovereign debt, creditors, debtors, and the official community had to invent methods as they went, a slow and often painful process. The initial response was to reschedule principal falling due and sometimes lend some new money. The country would agree to pay interest (usually at a reduced but still notionally market based, rate) on the rescheduled debt, using in fact, the new money lent plus whatever other resources it had. This greatly reduced the strain on the debtors’ foreign exchange position and allowed the creditor banks to book the loans as performing and record income from the interest payments, preserving their solvency. In order to accomplish such a rescheduling, all the outstanding loans had to be reconciled and creditors had to agree to redocument their claims into the new, rescheduled, instruments, which included sharing, *pari passu*, and other clauses to assure equal treatment of all banks. Given the large number of creditors and their differing interests, gaining full participation was never an easy job, and often quite difficult. But full participation (or very nearly) was required in order to make the deals acceptable to all creditors, including the IFIs and the creditor country governments, who were also supporting the debtors with new loans and Paris Club rescheduling.

Concerted reschedulings, some with new money, were a satisfactory temporizing solution for a number of countries. Overt default was avoided, though capital inflows dropped dramatically, and relations with banks were maintained, though often with considerable contention. Banks were able to maintain their
solvent while adjusting their business and asset structures, and a widespread crisis was averted. Concerted rescheduling did not prove to be a stable long-term solution, however. Countries were not able to recover sustained growth in the time periods expected (3-5 years), and commercial interests of the banks diverged increasingly, making concerted agreements ever harder to achieve. In addition, growth of transactions among banks in their loans to developing countries and later sales to third parties at substantial discounts from face or par values confirmed what many had argued all along: the assets were worth far less than values carried on books. It was further argued that by reducing debt burdens of the debtor countries, the probability of repayment on the remaining debt would be enhanced. Analogies to domestic bankruptcies and workouts were often mentioned.

**Regulatory Issues of Debt Reduction:** This led to the second stage of the debt strategy: officially sanctioned debt reduction under the Brady Initiative. Banks and debtors were encouraged to negotiate agreements to reduce the face value of debt and debt service, and the IFIs were encouraged to lend additional resources to allow the debtors to enhance the new, reduced value, instruments with interest and/or principal collateral. As with concerted rescheduling, there was considerable pressure from major creditor governments to move this process along. Creditors and debtors were able to devise a set of financial instruments that reduced the outstanding value and servicing burden of the debtors' commercial obligations while offering debt holders equal or greater value for their assets compared to their current "market" value. A significant portion of the debt treated in these operations has been converted from loans to bonds, and the links among creditors have been greatly reduced compared to the concerted reschedulings. This has increased the marketability of the obligations of the developing countries and will permit placement among a wider range of investors. These instruments are described in much more detail in this volume. What is important to note is that out of necessity, a crude surrogate for bankruptcy proceedings has evolved for sovereign debt. It is cumbersome and requires extended negotiations between creditors and debtors plus the involvement of the IFIs to design, fund, and monitor adjustment programs. It lacks any efficient enforcement mechanism beyond mutual interest, so it depends on reaching "voluntary" agreements. And it doesn't always work, in which case, bad relations between banks and debtor countries can drag on indefinitely without resolution. But in the end, it does constitute a generally accepted procedure for addressing sovereign debt defaults.

Parallel to the evolution of financial instruments and procedures for addressing sovereign debt issues has been the evolution of tax and regulatory treatment for such debt by creditor banks' governments. Even the so-called international banks are really nationally based banks operating abroad in a variety of modes. Each is subject to its own national legislation, regulation, reporting requirements, and accounting principles. These regulations and principles have grown out of differing national economic structures, financial histories, and national idiosyncrasies. While adhering to similar prudential and fiduciary objectives, their specific expression in regulatory norms can differ sharply from one country to another, much as the contract law governing debt differs from one jurisdiction to another. Differences in reserve requirements, provisioning rules, capital adequacy statutes and other regulations have real bottom line implications, particularly for national banks competing internationally. A number of recent banking crises have focused a great deal of attention on the consistency and adequacy of national financial regulation for
international financial stability, and considerable progress has been achieved under the auspices of the BIS to strengthen and make consistent basic regulations. Nevertheless, differences in national regulations, and their evolution over the past decade, have been an important factor in the working out of the debt strategy.

Quite apart from resolving problems of equal treatment and underlying business decisions about debt relief, banks have had to consider increasingly complex questions about the tax and regulatory treatment of assets in developing countries that were not being serviced on schedule. Some questions simply were not covered under existing regulations, some faced inconsistent rulings by different authorities in the same country, and others lacked clear interpretation by the governing authorities. And it took bank managers and accountants some time to analyze how different actions and applications of the rules affected their particular bank. Depending on their profit situation, other sources of income, etc., different banks found themselves advantaged or disadvantaged in different ways by the rules and interpretations. Working out the implications of regulations and tax law and awaiting key regulatory rulings have also delayed debt negotiations at various stages. Regulators themselves have had to tread a delicate path: balancing a need to preserve the integrity of their overall prudential systems while accommodating the special needs of international banks and their competitive situation; assuring the continued solvency of the international banking system without appearing to be bailing out the major banks; and maintaining a stable and consistent regulatory and tax environment while adapting to rapidly changing circumstances.

The issues in the early stage of the debt crisis were when and how much provisioning should be required or allowed against loans to developing countries where payment was in doubt, how provisions would be treated in relation to the capital of a bank, when provisions were deductible against taxes, and how to account for interest received and for new money loaned in the concerted packages. Rulings, interpretations, and new regulations eventually clarified most of these issues. Although vexsome, these questions were relatively simple in retrospect, for they did not involve questions of how to recognize and account for actual losses, both in profit and loss statements and on tax returns. Once the prospect of commercial debt reduction was officially countenanced, more difficult questions of accounting for losses, particularly the timing of their recognition became paramount. Rulings and interpretations in this area were affected by decisions that had been taken on the provisioning issue. In addition, the new instruments created in the Brady agreements, with their partial collateral and bonded structure, demanded further new tax and regulatory interpretations so banks could estimate the impact on their after tax profits. These have gradually emerged, covering nearly all the important questions.

**Analyzing of the Tax and Regulatory Environment:** The evolution of these tax and regulatory environments has been long and highly technical and complex. However, the rulings have had a profound effect on the structure and acceptability of various debt relief proposals and operations. Understanding the rules has been critical for debtors and creditors in the negotiations, as well as for other interested parties, such as the IFIs. To assist in this understanding, the Financial Advisory Services unit of the World Bank initiated a review of tax and regulatory issues in 1988 with the assistance of Price Waterhouse. As events unrolled and regulations were further modified, this work has been periodically updated and internal
reports issued. This body of information has been a critical element in the advisory support the World Bank has been able to provide to its member countries. The authors of this book, Jonathan Hay and Nirmaljit Paul, have carried the bulk of this work throughout the period. They have been assisted by many colleagues in the unit, elsewhere in the Bank, and in the regulatory agencies. While the pace of change in these regulations seems to be slowing as most issues have been resolved and as it does not look like major innovations are in the immediate offing, the descriptions contained here are still only a snapshot of the state of regulations as of mid 1991. They will undoubtedly evolve further as time goes on.

The authors have organized the book with the summary material in the beginning: descriptions of the debt reduction operations and the responses of the commercial banks to them, with particular attention to the influences of the tax and regulatory environments faced in each jurisdiction. The latter part presents much more detail of each creditor country's regulations and is intended to serve as a reference. As such, it is an important compilation of material not readily available in any other single source that I am aware of. It should be a valuable resource for further research and analysis of the debt crisis and the role played by the regulatory environment.

John D. Shilling
Washington, D. C.
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I. INTRODUCTION AND SUMMARY

Since the introduction of the market-based menu approach to debt reduction, specialists in developing country finance have had to refocus their thinking about the tax, accounting, and regulatory treatment of sovereign debt. This was because the market-based menu was designed to allow banks to choose financing options that best suited their individual tax and regulatory environments. Some policy makers were also interested in discovering whether or not there were tax and/or regulatory obstacles to voluntary debt reduction. Initially many of the transactions appearing in the market-based menus were relatively novel. It was unclear both what the appropriate accounting for the transactions would be and the extent to which differences in treatment would make a difference in bank participation in financing packages. At this time a significant number of operations have taken place; the market-based menu is no longer a new development; and precedents and policies have been established with respect to the tax, accounting and regulatory environment of these transactions. Much of this report is a presentation of these precedents and policies. These policies continue to evolve and each new financing package may contain nuances that require tax and regulatory officials to provide additional guidance to banks.

Although the general trend has been towards greater clarity in the tax, regulatory and accounting treatment of sovereign debt, some important areas of uncertainty remain. Some of these are discussed in the report. Two areas of uncertainty worth noting here are: (i) the tax treatment of interest capitalization; and (ii) provisioning requirements with respect to credit-enhanced instruments received in comprehensive debt reduction operations. These issues are discussed in greater detail in the text. It is likely that these issues will need to be clarified in future financing packages.

The interview results and data on bank choices presented in the report suggest that the tax and regulatory treatment of sovereign debt has had an impact on specific instruments chosen in financing packages. For example, the preference of French and U.S. banks for new money and the preference of Canadian and German banks for debt reduction in the Philippine package is consistent with the incentives created by the tax and regulatory regimes in these countries. However, the strength of these effects should not be exaggerated. The preference of Japanese banks for new money in the same package contradicted the tax incentives in realizing losses in debt reduction operations. For Japanese banks, long-term business and geo-political interests in the Philippines may have been the important factors in determining bank choices. In other cases, judgements about interest rates and country creditworthiness are likely to be more important in determining bank choices between instruments than differences in tax and regulatory treatment. The choices that U.K. banks made for par and discount bonds in the Mexican financing package are an example of this. The decision of banks to participate in financing packages does not appear to have been significantly influenced by tax and regulatory policy.

Tax and regulatory factors may have had some impact on the pricing of transactions, but, if current trends continue, this is likely to be less of an issue in the future. In an earlier World Bank report, it was argued that the credit enhancement needed to get banks to participate in voluntary debt reduction would be increased by the fact that many banks (particularly U.S. and French banks) had not recognized capital losses on their sovereign loans for regulatory purposes. A number of trends have made this less of a concern. These trends include: the progressive application of the Basle guidelines for excluding loan loss reserves from regulatory capital, the increase in commercial bank provisioning, and the decreased importance of LDC loans on commercial bank balance sheets. While these trends suggest that tax and regulatory factors no longer present significant obstacles to voluntary debt reduction for most banks, a small number of banks may continue to be constrained in their ability to participate in voluntary debt reduction. These constraints are, to some extent, a function of tax and regulatory policy.
Tax and regulatory policies will continue to be a consideration in negotiating the details of packages. As discussed in the text, new issues have arisen in almost every package. As a result, it is hoped the reader will benefit from the broad overview of the tax and regulatory treatment of sovereign debt that this report provides.

This report is structured as follows. Section I serves as an introduction and summarizes the report's conclusions. Section II outlines recent debt restructuring operations. Section III analyzes how commercial banks have responded to recent debt restructuring operations. Finally, Section IV gives a country-by-country analysis of the tax, regulatory and accounting treatment of voluntary debt reduction operations.
II. OUTLINE OF RECENT DEBT RESTRUCTURING OPERATIONS

In order to provide a basis for describing the response of tax, regulatory and accounting authorities to recent developments in the external commercial bank debt workout process in the heavily indebted countries, the basic elements of the Mexican, Philippines, Costa Rican, Venezuelan and Uruguayan packages are described in this section. The packages are described in greater detail in General Annex 1.

Mexico

After nearly one full year of negotiations, Mexico was the first country to reach agreement on debt and debt service reduction with its commercial bank creditors. Due to the complexity of the agreements reached, it took several months to settle crucial details and for all of the concerned banks to respond; the pact was eventually finalized in February, 1990. It was a comprehensive agreement, covering all the reschedulable commercial bank debt (some 85% of all commercial bank claims on Mexico). The agreement initially rescheduled all the eligible debt for 16 years with 4 years of grace, then offered banks the option of providing new money equal to 25% of their exposure over 4 years without enhancement or converting their rescheduled debt into bonds with either a reduced face value (65%) and market based interest rate (LIBOR + 13/16%) or the same face value but a reduced and fixed interest rate (6.25%). Both bonds have 30 year "bullet" maturities and are enhanced by having the principal defeased or collateralized through the pledging of zero coupon US treasury securities (or equivalent credit quality in other currencies) and by 18 months' rolling collateral on the interest payments. There are also provisions for some interest recapture by the banks if oil prices rise, for buybacks or debt exchanges by Mexico so long as it is current in debt service obligations, and for secured new money borrowings. The enhancements are funded by resources drawn from the World Bank, the IMF, Mexico's reserves, and (indirectly) the Japanese EXIM Bank. Nearly all enhancements were committed at signing, with a partial commercial bank bridge loan to the remaining enhancements.

Apart from a direct reduction in debt service obligations and other indirect economic and financial benefits, Mexico obtained a comprehensive restructuring of its external commercial bank debt with expanded future rights to further reduce its obligations to private creditors through direct buybacks or other transactions. Broad-based participation was achieved by offering a menu of options via the debt exchange provisions which were agreed at the time of the 1987 rescheduling and new money operation. Thus, Mexico did not require unanimous waivers from its bank creditors on this occasion. By relying on the legal flexibility obtained in 1987, Mexico could exert a degree of pressure on would-be "free (or cheap) riders". For example, by converting from an interlocking set of rescheduling agreements to a series of independent bond issues, Mexico was in a position to give the holders of 1990 bonds and new money instruments, special rights to debt equity conversions, while residual holders of old debt would no longer possess payment sharing claims against creditors who had converted their claims into bonds, in the event of differential payment to such bondholders. Moreover, the future burden of principal repayment was removed by effectively prepaying the exchanged bonds via the zero coupon bond collateralization. Part of the remaining interest obligations were fixed (par bonds), reducing future uncertainty with regard to interest payments, and a contingency fund for 18 months' worth of interest was also put in place. The treatment of the commercial bank debt was thus intended to be definitive, and the Government will not have to face future debt restructuring negotiations so long as it is able to meet its reduced debt service obligations.

The banks also achieved several objectives. The enhancement of the debt repayment and interest payment obligations plus the country's lower debt burden and reinforced adjustment program reduce the risk the banks face on the remaining debt outstanding. They were able to secure nearly all the enhancements upfront, eliminating part of the risk that deficiencies in
the government's performance would delay the delivery of enhancements. The agreement is considered definitive by the banks, and many intend to treat the bonds as exit instruments, either by holding them and insisting on their exclusion from future restructuring or new money calls or by selling the claims. Interest payments beyond the 18-month collateralized period, however, remain Mexican risk and enjoy no legal seniority or other special protection. Banks also received relatively favorable regulatory treatment of the conversion bonds in most jurisdictions. Arrangement of the bridge loan from a group of commercial banks (to accommodate the delayed delivery of a portion of the official funding for credit enhancement) proved, however, to be particularly difficult and contentious. Some banks argued that it represented unfair burden sharing, since they were being asked to fund temporarily part of the enhancements that were supposed to be supplied by the official sector.

It was anticipated at the outset that the majority of banks would choose the low interest bonds, and that the remaining banks would be about equally split between the new money and discount bond options. It turned out, however, that few banks chose new money. While the reduction in interest obligations had an important impact, Mexico's debt service obligations were reduced to a greater extent by the effective rescheduling and collateralization of principal. The smaller amount of new money than anticipated reduced the short term cash flow, but not to a greater extent than could be absorbed in reserves, particularly since the oil price was higher than expected during the semester following the conclusion of the operation. A contingent financing facility to be called in the event of lower than expected oil prices (with a proposed World Bank guarantee feature) was agreed in principle by a limited number of major creditors, but was never concluded.

In terms of its overall structure, the Mexico agreement was comprehensive and concerted. While banks were given options, they were expected to participate, and a considerable degree of official pressure was exerted to bring the negotiations to a close with virtually all banks participating. The options were designed to be broadly equivalent in benefit to Mexico, but offered banks the opportunity to pick the option most advantageous to their particular circumstances.

Philippines

The most straightforward of the "Brady Plan" agreements achieved so far is the one the Philippines announced in October, 1989. After a short round of negotiations, the Philippines and its commercial bank creditors decided to propose granting waivers and entertaining a buyback of part of the Philippines' debt at a 50% discount. Debt not repurchased would have its interest rate reduced to 13/16% over LIBOR, and banks would be asked to provide new money in the form of either bonds or loans equivalent to about 15% of their holdings over two years on the same terms as the existing rescheduled debt, which was still covered under the 1985 agreement (i.e., 15 years maturity with an 8 year grace period). The bonds would be explicitly excluded from any new money base in the future. Banks contributing new money would be allowed to convert an equivalent amount of their earlier 1985 new money commitment (up to a maximum 50%) into bonds, thereby placing both the new money bonds and that share of the 1985 new money debt outside the base for future new money calls or rescheduling. The Philippines also negotiated the right to spend up to US$1.5 billion (directly or indirectly from official resources) before the end of 1991 for debt buybacks, of which $650 million was used in this operation. In addition, up to US$200 million per year may be used from any source for debt reduction after 1991 or after the $1.5 billion is fully utilized, whichever occurs first.

Initial soundings made by the Philippines had indicated about $1.3 billion of debt would be tendered for a buyback and up to $1.0 billion in new money would be provided, and it was on this basis that the operation was launched (with the buyback offer limited to a total face value of US$1.3 billion, matching US$650 million in identified resources from official sources...
and reserves for the purchase). However, the actual preferences of the banking community when firm commitments were sought showed less interest in the new money option, more interest in the buyback, and more banks taking advantage of the voluntary character of the agreement by free (or cheap) riding, i.e. participating in neither option. In the buyback of the US$1.3 billion, the Philippines authorities had to select from a total of $1.8 billion in debt tendered. Some of the debt tendered was ineligible for the buyback, but a substantial amount of eligible tendered debt was also rejected due to the lack of resources to repurchase more than $1.3 billion. Some of the rejected debt has reportedly been sold on the secondary market, reflecting the growing preference of banks to exit. The new money component was delayed by one month in order to try to attract greater participation. It was settled in February 1990 at an amount of just over US$700 million.

This agreement was more voluntary than the Mexican one. It was not comprehensive and official pressure on banks to participate was insignificant. It was designed to meet the Philippines' financing requirements for 1990-91 and at the same provide smaller creditors having little long-term interest in the Philippines a possibility to exit with a one time loss, while maintaining a core group of larger creditors with long-term interest who would provide new money and maintain the face value of their assets. The agreement was not intended to provide a definitive solution to all the debt, a fact which helped speed the negotiation process, as did the fact that the Bank Advisory Committee was not asked to agree unanimously on the terms of a full menu of options. The Philippines gained from a reduction in its commercial bank debt stock and thus lower debt service obligations, while maintaining positive banking relations with the group of long-term creditors. The operation provided less cash flow relief for the Philippines than desired, in part because the new money component turned out smaller than hoped for and in part because the IFIs made only set asides available for the funding of the buyback operation. Bilateral support was partly additional.

Costa Rica

After protracted and difficult negotiations, Costa Rica reached an agreement for a debt and debt service reduction operation in November 1989. A major complication in the negotiations between Costa Rica and its commercial bank creditors was the existence of arrears. Costa Rica had paid only part of its interest obligations for several years, and by November 1989 had accumulated interest arrears of some US$325 million on commercial bank debt. The agreement between Costa Rica and its advisory committee covered practically all commercial bank debt including arrears, a total of some US$1.8 billion. Banks were given the option of either selling their Costa Rican assets, including arrears, to Costa Rica at 16 percent of their face value, or exchanging them for long-term, low-coupon bonds. Principal and arrears were repurchased separately but at the same price to allow for the different amounts of arrears associated with different debt instruments. For $1 face value of original debt, the price of this debt plus its accumulated arrears was about 19 cents on average.

Banks offering to sell at least 60% of their assets received bonds with a shorter grace period and tenor for the remaining share of their assets than did banks offering less than 60% of their assets for the buyback. In addition, the former have 12-18 months of interest payments collateralized. An upfront payment of 20% of the arrears not repurchased was made to participating banks, while it was agreed that the remaining part of the arrears would be paid over 15 years. Collateral for three years of these payments will be provided for banks offering at least 60% of their assets for the buyback.

The agreement was comprehensive and concerted, calling for the participation of all creditor banks. In fact, Costa Rica made it clear that the package would be accepted only if holders of at least 95% of eligible debt participated. There was no request for new money, which, along with the involvement of all commercial bank debt, made the agreement a form of exit vehicle for
commercial bank creditors. It is not anticipated that Costa Rica will return to commercial bank borrowing in the foreseeable future, leaving future financing burdens primarily for the official creditors. This last point was understood and accepted by the Costa Rican Government before the strategy was pursued. The deal with the commercial banks was closed in May 1990.

Venezuela

On March 20, 1990, Venezuela reached an agreement in principle with its Bank Advisory Committee. The agreed menu included four basic options: new money linked to the conversion of existing debt into bonds; temporary interest reduction bonds; reduced principal bonds and reduced interest bonds similar to those in the Mexican agreement; and short term (91-day) discount notes.

The new money and debt conversion bonds were intended to be the means by which banks could opt to contribute new money rather than accept a reduction in the face value of the original loan or a below-market interest rate. The new money bonds have a 17 year final maturity and a 7 year grace period. There were two series of these bonds - one series carrying an interest rate of 1% over LIBOR and the other series, a rate of 7/8% over LIBOR. For each $1 committed to the new money bonds, a creditor was entitled to exchange $5 of old debt at par for debt conversion bonds. The debt conversion bonds have a 17 year final maturity, a 7 year grace period, and an interest rate of 7/8% over LIBOR. The new money and debt conversion bonds are not supported by any collateral for either principal amortization or interest payments.

The second menu option involved a temporary reduction in the interest rate. These bonds are designed to be attractive to banks wanting a moderately enhanced instrument that is not tied to any new money commitment. On these US dollar bonds, the interest rate would rise from 5% per annum in the first year to a market based rate (LIBOR + 13/16%) in the sixth year. The bonds have a 7 year grace period and a 17 year final maturity. The bonds were exchanged for old debt at par. The only enhancement included was an escrow account sufficient to cover interest payments for 12 months during the five years of reduced interest rates. There was no collateralization of principal.

The third set of instruments included bonds similar to those in the Mexican agreement which offer more substantial enhancements than the option just mentioned. As in the Mexican agreement, there were two types of these bonds: discount bonds and par bonds. The discount bonds were exchanged for old debt at a 30% discount from face value. The interest rate on the discount bonds was 13/16ths over LIBOR. The par bonds were exchanged for an equivalent face value of old debt but would carry a below-market fixed rate of 6.75% for the US dollar bonds. Both types of bonds were enhanced by full collateralization of principal using a 30-year zero coupon bond and by protection of 14 months of interest payments using escrow accounts. In addition, these bonds have a “value recovery” feature - detachable oil warrants. These warrants entitle the holder to receive a payment when the reference price of oil exceeds a specified level in the sixth year or thereafter, subject to an overall ceiling.

Finally, the package included 91-day short term discount notes which essentially replace a cash buyback option. The notes were exchanged for old debt at a discount of about 55%. This instrument was a surrogate cash buyback.

Due to the complexity of reaching agreement on the final terms, the banks’ firm commitments to the menu items were not made until November 1990. There was an increase in oil prices albeit for an uncertain period of time. Banks accounting for 31% of the total commercial bank exposure in Venezuela selected the new money option. 7% selected the discount note, 37% par bonds, 9% discount bonds and 15% temporary interest reduction bonds.
Uruguay's negotiations with its Bank Advisory Committee to agree on a Financing Plan were concluded in November 1990. The entire US$ 1.61 billion of commercial bank debt most recently rescheduled on March 4, 1988 and collectively referred to as MYRA debt, was defined to be eligible for the proposed DDSR operation. The Eligible Debt amounted to about 50% of Uruguay's US$3.2 billion outstanding medium and long-term public and publicly guaranteed external debt. A term sheet with the following menu of options for creditors was made available on November 5, 1990, and presented to all creditors on November 15 and 16, 1990:

(i) cash buyback

(ii) a 30 year fixed rate bond

(iii) a debt conversion bond with a new money provision for debt that is not tendered under options (i) and (ii). This is in essence a rescheduling (16 year MYRA with seven year grace) tied to new money.

Early participation fees were available to creditors who committed their eligible debt by December 7, 1990. Uruguay and its Bank Advisory Committee signed the agreement related to the Financing Plan on January 31, 1991, and implemented the transaction on February 19, 1991.

Description of the Instruments

The Cash Buyback was offered to creditors at a rate of US$0.56 per US$1.00 of Eligible Debt. This rate was higher than the secondary market price of Uruguayan debt at the time the term sheet was finalized, in order to increase the attractiveness of this option to participating banks.

The Fixed Rate Bond is issued in registered form by the Central Bank of Uruguay. Under this instrument, creditors receive the full amount of their outstanding principal claims on Uruguay in a single payment on the 30th anniversary of the date of issuance of the instrument. The principal amount of this note is fully collateralized by the pledge of securities with matching value and maturity date. Interest payments based on a fixed rate of 6.75% for the 30 year life of the instrument are partly collateralized, on a roll-over basis for the entire period, by the pledge of cash or permitted securities in an amount equal to 18 months of interest payments. Earnings on the interest collateral account will accrue to Uruguay, such that the amount pledged with the Collateral Agent will remain constant, at 18 months' interest obligations.

To compensate holders for the 30 year below-market interest rate, the Fixed Rate Bond contains a value recovery provision in the form of a possibility for supplementary semi annual payments beginning in 1996. All Fixed Rate Bondholders will have the opportunity to share in Uruguay's future upside economic potential as indicated by an increase in the Commodity Terms of Trade Index beyond the value of 110. The index is based on prices of beef, rice, wool and oil.

Finally, as an alternative to an instrument involving debt reduction (i.e the cash buyback) or debt service reduction (i.e the fixed rate note), banks were permitted simply to reschedule their existing obligations, provided that they agreed to purchase New Money Bonds amounting to 20% of the exposure submitted for rescheduling. Rescheduling of existing obligations was carried out by means of Debt Conversion Bonds, which have a 17 year life with a 7 year grace period, and carry an interest rate of LIBOR+7/8%. The corresponding New Money Bonds...
Bond, representing a US$1 increase in exposure for every US$5 tendered by the creditor under the Debt Conversion option, has a tenor of 15 years with 7 years' grace, and the interest rate is LIBOR+1%. Both the New Money Note and the Debt Conversion Note are uncollateralized instruments.

Responses of Commercial Bank Creditors

Creditors holding Eligible Debt responded favorably to the Plan. By December 17, 1990, the cutoff date for the buyback offer at US$0.56, all creditors had committed to one or more options offered to them, and the entire US$1.61 billion of eligible debt had been submitted. About 89% of the debt had in fact been submitted by December 7, 1990, which was the cutoff date for the early participation fee.

The choices of the creditors revealed a strong preference for maintaining claims on Uruguay. Of the US$1.61 billion submitted, US$982 million (61%) was exchanged for instruments involving no reduction of principal value. Furthermore, US$447 million (28%) was exchanged for instruments that not only have both principal and interest payments uncollateralized, but also call for additional uncollateralized exposure in the amount of US$90 million. This confidence on the part of creditors would appear to be based on Uruguay's unblemished debt servicing record throughout its period of economic difficulty.
III. ANALYSIS OF COMMERCIAL BANK RESPONSES

This section outlines some of the considerations influencing bank choices, compares the choices that banks made in recent restructuring packages and speculates about some of the reasons for those choices and describes the results of interviews conducted with banks from a number of countries.

Factors Influencing Bank Choices

The tax and regulatory policies which are most likely to influence bank participation in financing packages are those which affect the timing of loss recognition for regulatory and tax purposes. Regulatory policy may create incentives for banks by determining the extent to which they must recognize capital losses through provisioning, charge-offs or as a result of participating in exchanges and restructurings of their existing loans. In order to understand the incentives that may be created by regulatory policies, it is important to distinguish between the actual losses on sovereign loans and the recognition of losses. Due to the way in which banks are regulated, the recognition of losses per se may have costs for banks. This is because commercial banks are required by law to operate with a minimum ratio of capital to assets. The recognition of a capital loss reduces the maximum assets that a bank can leverage and still remain in compliance with its legal capital requirements. The effect of recognizing capital losses may be particularly important for banks that are operating at or near the minimum capital asset ratio mandated by bank regulators. Commercial banks, consequently, have an incentive to hold assets which allow them to delay the recognition of capital loss.

The value for banks of delaying the recognition of capital loss has important consequences for understanding the incentives that regulatory policy may create with respect to participation in voluntary debt reduction. Policies which require banks to recognize capital losses on their developing country claims are likely to make some forms of voluntary debt reduction easier to achieve. This is because increasing the amount of capital required on unsecured developing country claims raises the cost of funding such assets and makes holding cash or some more secure asset relatively more valuable to banks. On the other hand, policies which have required banks to allocate relatively little regulatory capital to their existing assets might discourage these banks from participating in forms of voluntary debt reduction which entail the recognition of an upfront capital loss.

While the recognition of capital loss has costs, there may be some benefits that offset the costs of recognizing losses. To the extent that banks are able to obtain tax deductions (that they could not otherwise obtain) upon recognizing a capital loss, the cost of recognizing such losses will be reduced. However, even where banks are able to obtain more of a tax deduction as a result of recognizing a capital loss than would otherwise be possible, this may have little value for banks that have substantial losses and low profitability. This may be especially true for some large United States banks that must carefully schedule their losses in order to be able to make use of accumulated foreign tax credits.

In theory, it might be expected that banks would carefully compare and be influenced by the tax and regulatory consequences of accepting different instruments, and that, therefore, it should be possible to make some generalizations about incentives created by a particular regulatory and tax structure and the way in which banks are likely to respond. But several caveats are in order.

First, in some cases the relevant consequences which affect the value of instruments may be so particular to the tax and regulatory situation of an individual bank, that it may be difficult to make generalizations about the incentives created by tax and regulatory policy.
This is especially likely to be true with respect to the tax consequences of accepting different instruments.

Second, bank choices may be influenced by long-term business objectives. The contributions of Japanese banks to the new money component of the menu in the Philippines financing package is an example of such a choice.

Third, in interpreting banks choices it is important to keep in mind that the value of different instruments in a financing package are determined to a large extent by expectations with respect to interest rates and currency values and by perceptions of underlying credit risk. Even if banks construct careful financial models which take tax and regulatory effects into account, the value of instruments may, in many cases, be more sensitive to other more fundamental variables, such as expected interest rates and perceived credit risk.

With these caveats in mind it is possible to make some general observations about the incentives created by particular tax and regulatory regimes and the way in which these incentives may have influenced the choices that banks actually made.

**Mexican Financing Package**

Table 1 below shows the choices that banks made in the recent Mexican Financing Package. The table shows the total percent of debt exchanged for particular instruments by banks from a particular country.

<table>
<thead>
<tr>
<th>Country</th>
<th>Par Bond</th>
<th>Discount Bond</th>
<th>New Money1/</th>
</tr>
</thead>
<tbody>
<tr>
<td>France</td>
<td>79%</td>
<td>9%</td>
<td>12%</td>
</tr>
<tr>
<td>United States</td>
<td>58%</td>
<td>24%</td>
<td>19%</td>
</tr>
<tr>
<td>Japan</td>
<td>18%</td>
<td>81%</td>
<td>0%</td>
</tr>
<tr>
<td>Canada</td>
<td>48%</td>
<td>52%</td>
<td>0%</td>
</tr>
<tr>
<td>Germany</td>
<td>80%</td>
<td>20%</td>
<td>0%</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>48%</td>
<td>45%</td>
<td>6%</td>
</tr>
</tbody>
</table>

1/ New Money figures show the new money base (as a percentage of total commercial bank claims) according to which new money contributions are calculated.

Obviously to the extent that banks expected interest rates to rise the discount bond would have been more attractive. It is possible to explain these choices as a function of banks' expectations about interest rates. And as discussed below, some of the banks interviewed made statements to that effect. On the other hand, the choices are broadly consistent with those that would be expected given the tax and regulatory incentives created by existing regimes.
French Banks

For example, French banks almost universally chose the par bond. This result is consistent with the regulatory and tax advantages associated with this choice. The choice is attractive from a regulatory point of view because the banks need not recognize capital losses upon the acceptance of the par instrument. This may be especially important for some of the French banks that are known to be struggling to meet the Basle guidelines for capital adequacy. For a similar reason, it is not surprising that 3 of the 4 largest French banks also participated in the new money package.

Figures show the amount and percent of debt exchange instruments prior to the exchange. In the case of new money, figures show the new money base (i.e. the base exposure on which new money contribution is computed).

From a tax point of view, the discount bond is slightly more attractive than the par bond. Both bonds receive favorable treatment in the sense that the October 10, 1989 letter from the Director of the Treasury to the French Bank Association exempts the bonds from the normally unfavorable tax treatment applied to losses on securities. But in both cases, provisions against the bonds must be recaptured over the life of the asset. In the case of the par bonds all the provisions must be recovered. But in the case of the discount bond, the large upfront loss is "locked in" and need not be recaptured. The difference is subtle and is partly, although not completely, offset by the fact that interest stream and, hence, tax payments are higher in the case of the discount bond. The bottom line is that the expected present value of taxes payable in the case of the par bond is slightly higher than the expected present value of taxes due in the case of the discount bond.
French Banks - Interview Results: In interviews, three out of four French banks interviewed stated that the regulatory treatment of the par bond was decisive. Being able to avoid the recognition of capital loss made the par bond more attractive. The fourth bank exchanged 68% of its debt for par bonds, 12% of its debt for discount bonds and contributed 20% of its base exposure in new money. The bank argued that this mixture was designed to "stabilize its country-risk exposure". The bank also pointed to the tax treatment of the discount bonds as an important factor in deciding to take proportionally more of these bonds than did other French banks.

United States Banks

Similar arguments could be made about the choices of United States banks. U.S. banks strongly favoured the par bond as a debt reduction instrument. But the argument that the par bond is more attractive than the discount bond because it allows banks to avoid the recognition of capital loss is weakened slightly by the fact that the SEC letter describing the appropriate accounting treatment for the instruments (see Annex 1 to US section under Part IV - Creditor Country Analysis - of the paper below) would allow banks to avoid the recognition of loss in both instances, so long as the nominal value of the expected cash receipts equals or exceeds the face value of the existing asset. The argument is also weakened by the fact that some of the US banks that participated in the exchange recorded losses upon exchanging their loans for the new assets.

Nevertheless, some banks did not record losses upon the acceptance of par and discount instruments, and the degree of loss recorded varied from 25% to almost 60%. With one or two exceptions, banks that chose the par bond did record less of a loss than those that chose the discount bond. Generally, the par bonds were not subjected to a write-down, while a 35% charge was taken by the majority of banks accepting the principal-reduction bonds. As mentioned above, a few banks recorded losses on both bonds. It seems that although banks could technically account for both the discount and par bond without recognizing a loss, banks and their accountants were more comfortable with this treatment in the case of the par bond than in the case of the discount bond.

![Pie chart showing the distribution of Mexican debt to United States banks. The chart indicates that 58% of the debt was in par bonds, 24% in discount bonds, and 19% in new money base. The remaining 5% is not shown.](chart.png)
Table 2
Accounting Treatment of the Mexican Debt Exchange

<table>
<thead>
<tr>
<th>Bank</th>
<th>Net Charge-Off Recorded</th>
<th>Instrument(s) Chosen</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank of New York</td>
<td>35%</td>
<td>DB</td>
</tr>
<tr>
<td>Bank of America</td>
<td>0%</td>
<td>PB, NM</td>
</tr>
<tr>
<td>Chase Manhattan</td>
<td>35%</td>
<td>DB, PB</td>
</tr>
<tr>
<td>Citicorp</td>
<td>0%</td>
<td>NM</td>
</tr>
<tr>
<td>J.P. Morgan</td>
<td>40%</td>
<td>PB</td>
</tr>
<tr>
<td>Bankers Trust</td>
<td>0%</td>
<td>DB, PB</td>
</tr>
<tr>
<td>Chemical Bank</td>
<td>0%</td>
<td>DB, PB</td>
</tr>
<tr>
<td>Manufacturers Hanover</td>
<td>35%</td>
<td>DB, PB</td>
</tr>
<tr>
<td>First Interstate</td>
<td>35%</td>
<td>DB</td>
</tr>
<tr>
<td>First Chicago</td>
<td>53%</td>
<td>PB</td>
</tr>
<tr>
<td>Mellon Bank Corp.</td>
<td>25%</td>
<td>PB</td>
</tr>
<tr>
<td>Continental Bank</td>
<td>40%</td>
<td>DB, PB</td>
</tr>
</tbody>
</table>

DB= Discount Bond; PB= Par Bond; NM= New Money
Source= Salomon Brothers

As discussed in the US section above, the tax treatment of the par and discount bond differs. In the case of the par bond, the original issue discount method must be applied and in the case of the discount bond, banks would probably have been able to claim losses down to the fair market value of the asset. The discount bond seemed to offer the possibility of recording larger tax losses. However, banks with excess foreign tax credits may have preferred the par bond from a tax point of view because the par bond would have allowed them to delay the recognition of some of the tax loss. Banks with profits and the ability to use more deductions should, for tax purposes, have preferred instruments in the following order: discount bond, par bond and new money. This ordering would allow banks to accelerate the recognition of tax loss on these instruments to the maximum extent possible. In theory, this preference ordering should have been reversed for banks that cannot use the tax losses and would prefer to delay the recognition of tax loss.

US Banks - Interview Results: While, the tax consequences of choosing a particular instrument were very complicated and particular to individual banks, they were also clearly important. One of the four US banks interviewed cited the tax treatment of the par bond as the crucial factor in determining their choice. However, the bank came to the conclusion, unlike the authors of this report, that the par bond would give deeper tax losses than the discount bond! Another bank cited expected movements in interest rates as the crucial factor determining their choice. A third bank selected the par bond for a combination of reasons: that it allowed the bank to recognize some tax loss while avoiding the recognition of capital loss, and it had a higher economic value because of the bank's expectations on interest rates. A fourth bank, that chose neither of the debt reduction instruments, argued that its "business strategy was not compatible" with taking losses on its loans to Latin American countries.

Japanese Banks

Japanese banks overwhelmingly chose the discount bond. In Mexico, 18% of their exposure was exchanged for par bonds and 81% for discount bonds. Given the fact that the regulatory and tax treatment of the par and discount bond were identical according to MOF guidance issued at the time of the transaction, it is difficult to make the claim that tax and
regulatory factors determined this result. Before the Ministry of Finance guidance was issued there was some speculation among bankers that tax deductions would be denied in the case of the par bond. This proved not to be the case. It still might be true, however, that some banks felt more comfortable with the idea of claiming a tax loss on the discount bond than the par bond.

Japanese banks contributed no new money to the package. This result is consistent with the tax incentives provided by allowing banks to take a deduction upon participation in debt reduction. As described above, Japanese banks have been allowed to deduct very small amounts of their sovereign exposure outside of debt reduction operations. The opportunity to realize losses makes participation in debt reduction relatively more attractive for Japanese banks. Because sovereign loans constitute a very small percentage of the exposure of most Japanese banks, the capital cost of recognizing losses does not seem to be as great a concern to Japanese banks as it is to capital constrained banks from other countries.

**Japanese Banks - Interview Results:** Four large Japanese banks were interviewed for this report. The dominant reasons for choosing debt reduction over new money seemed to be (i) that the banks perceive Mexico to be a poor long-term credit risk, such that new money lending is not warranted and (ii) that the banks could realize a tax deduction upon participation in debt reduction. The dominant reasons for choosing the discount bond over the par bond were that the discount bond would allow the banks to reduce their base for future new money calls and would minimize interest rate risk because they carry a floating rate of interest.

The banks' individual responses were as follows. One bank cited reduction in its Mexican exposure, interest rate risk and the desire to realize tax losses as the dominant reasons for choosing the debt reduction option over new money. Another bank argued that it chose debt reduction because it did not want to increase provisions on new money. Increasing provisions, the bank argued, would have a high capital cost. The same bank also argued that the credit risk in Mexico did not warrant new money lending. A third bank argued that its choice of discount bonds could be justified on the grounds that they would reduce official exposure to the country, minimize interest rate risk, and reduce the bank's base for future new money calls. The fourth bank interviewed argued that it considered its loans to Mexico to be non-recoverable and that it had, therefore, decided to exit from the country. This bank also argued that it considered discount bonds superior to par bonds because the discount bonds would reduce their new money base and minimize interest rate risk.

**Canadian Banks**

Canadian banks contributed no new money to the package and split their participation in debt reduction by exchanging 48% of their debt for par bonds and 52% for discount bonds. From a tax and regulatory point of view the preference for debt reduction over new money is encouraged by the mandatory 35% provision required against loans to Mexico. Also banks have already recognized significant capital losses on their existing assets and as a result would be required to recognize correspondingly less of a capital loss upon participation in debt reduction. From a tax point of view, the debt reduction operations in the case of Mexico resulted in no additional tax loss for Canadian banks to participate in debt reduction. Their choices suggest that they considered the capital and other costs associated with making new money loans to be higher than the benefits of lower taxes and higher income associated with new money loans and tax deductible provisioning.
Canadian Banks - Interview Results: Three Canadian banks were interviewed for this report. Two banks selected the par bonds and the third bank selected the discount bonds. None of the banks selected the new money option because of the 35% minimum provisioning requirement on new money loans. One bank was reserved up to 70% of its exposure. New money lending would either lower this percentage or would require expensive new provisions; it wanted neither. This bank also said that it wanted to reduce its exposure in Mexico and new money lending would run counter to this objective. Finally, this bank said that if new money was provided and additional reserves created up to 70% of face value of the new loans, an additional tax liability on 25% of this face amount would be created since tax deduction for a maximum of 45% is permitted on reserves.

Two banks preferred par bonds over discount bonds because: (i) they expected interest rates to decline in the long run; (ii) par bonds do not have to be written down; and (iii) collateral can be deducted in calculating exposure and reserve requirements and this is higher for the par bonds. The third bank preferred the discount bonds over the par bonds because the former had lower interest risk due to a floating interest rate.
German Banks

German banks contributed no new money to the Mexican financing package and strongly favored the par bond to the discount bond. From a tax and regulatory point of view the preference for debt reduction over new money is encouraged by the mandatory provision required against new loans to Mexico. Also banks have already recognized significant capital losses on their existing assets and as a result would be required to recognize correspondingly less of a capital loss upon participation in debt reduction. From a tax point of view, the debt reduction operations in the case of Mexico resulted in little additional tax loss for German banks. Making new money loans on the other hand would create an additional tax deduction equal to about 50% of the face value of the loan. To the extent that tax and regulatory factors were related to the choice of German banks to participate in debt reduction and not new money, their choices suggest that they considered the capital and other costs associated with making new money loans to be higher than the benefits of lower taxes and higher income associated with new money loans and tax deductible provisioning.

Another very important reason for preferring the debt reduction bonds to new money is that German banks were able to receive their bonds in bearer form. Bearer bonds do not require capital backing under current German regulatory guidelines.

It is more difficult to find tax and regulatory justifications for favoring the par bond over the discount bond. In theory, there should be no difference in accounting for the discount bond and the par bond. Some German auditors interviewed for this report argued that the only difference was the "cosmetic" difference that some German banks might believe that it would be easier to argue for a tax deduction in the case of the discount bond than in the case of the par bond. However, if this incentive exists it runs counter to the actual choices that German banks made when presented with the menu of options in the Mexican package. It may be that the choice was influenced primarily by expectations about interest rates. On the other hand, it may be that in practice banks are accounting for these instruments differently than theory would suggest.
United Kingdom Banks

Two United Kingdom banks (Lloyds and Standard Chartered) participated in the new money package. With respect to DDSR, U.K. banks converted 60% of the debt exchanged into par bonds and 40% of the debt exchanged into discount bonds. As in the case of Canada and Germany, U.K. banks may have been discouraged from making new money loans by the fact that essentially mandatory provisions would be required against new loans.

As described in analysis of above of tax and regulatory developments in the United Kingdom, the tax treatment of the discount bond was slightly more favorable than the par bond. The intuitive reason for this is that the discount bond "locks in" tax losses, whereas they must be recovered in the case of the par bond as the value of the collateral increases to be equal to the face value of the asset received.

UK Banks - Interview Results: The U.K. banks that were interviewed acknowledged the tax effect described above. Most of the banks interviewed, however, indicated that the value they placed on the par and discount bonds was more sensitive to their judgments about Mexico's creditworthiness and interest rates than to the slight changes in value created by tax and regulatory distortions. In addition, two of the banks interviewed stated that there was some confusion about the tax and regulatory treatment of the instruments issued in the financing package. Because these issues were clarified relatively late in the process it was difficult to incorporate some of the more subtle effects of taxes and regulations into financial models for calculating the expected value of the items in the package.
Philippine Financing Package

Of the total $5.9 billion debt eligible for restructuring, $1.8 billion was tendered for buyback under the Philippine financing package. Of this amount only $1.3 billion was accepted. In addition, new money in the amount of about $700 million was provided by the banks.

**Table 2** below shows the choices made by the banks in the Philippine package in respect of the new money and buyback options. Of the amounts tendered for buyback, those accepted and rejected are shown separately. The new money option was chosen predominantly by banks in France, U.S., Japan and, to a lesser extent, in U.K. The Philippine package was seen by a majority of banks as basically different from the Mexican package. It was considered more voluntary and less of a comprehensive settlement of debt. For many banks, long term business interest, geo-political interests of their governments and other strategic factors were seemingly more important than tax, accounting and regulatory factors.
Table 2
Bank Choices in the Philippine Package

<table>
<thead>
<tr>
<th>Country</th>
<th>Tendered</th>
<th>Accepted</th>
<th>Rejected</th>
<th>New Money</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>18%</td>
<td>13%</td>
<td>5%</td>
<td>82%</td>
</tr>
<tr>
<td>Japan</td>
<td>41%</td>
<td>30%</td>
<td>11%</td>
<td>59%</td>
</tr>
<tr>
<td>Canada</td>
<td>100%</td>
<td>66%</td>
<td>34%</td>
<td>0%</td>
</tr>
<tr>
<td>Germany</td>
<td>81%</td>
<td>41%</td>
<td>40%</td>
<td>19%</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>54%</td>
<td>43%</td>
<td>11%</td>
<td>46%</td>
</tr>
</tbody>
</table>

French Banks

An overwhelming majority of French banks (96% by exposure) selected the new money option in the Philippines package. Only $25 million was offered for buyback of which $19 million was accepted. French banks were generally reluctant to offer their debt for buyback due to the adverse regulatory impact of this option.

French Banks - Interview Results: One major bank interviewed cited the negative regulatory impact of the buyback as the decisive factor in its choice of the new money option. This bank also felt that the buyback price of 50 cents per dollar of face value was too low. Another major bank chose a combination of the new money and the buyback options. It felt that the Central Bank of Philippines had not issued clear guidelines in respect of the buyback modalities, particularly as to which claims and what amounts would be eligible for buyback. It
understood that only limited amounts and late maturities would be eligible and small exposure would receive preference.

United States Banks

A majority of U.S. money center banks chose the new money option in the Philippine package, and a number of these banks also selected the buyback option. A number of U.S. regional banks and other small-exposure banks, however, selected the buyback option primarily as an exit vehicle. From the viewpoint of the large banks, long term business interest, view of the Philippines’ long term economic prospects and its continued need for new money support, were the overriding factors in selecting the new money option. Tax and regulatory factors were apparently less important.

U.S. Banks - Interview Results: Four large U.S. banks were interviewed for this report. All four selected the new money option, and two of these also selected the buyback option. Three banks cited long term business strategy and view of the Philippines’ long term prospects as reasons for new money support. The banks selecting the buyback apparently did so to reduce their exposure in Philippines. None of the banks interviewed cited tax or regulatory factors as being dominant in their choice of instruments.

Japanese Banks

A large portion (59%) of the exposure of Japanese banks accounted for the new money option, while 41% was tendered for buyback (of which 30% was accepted). Most large Japanese banks selected the new money option, while smaller banks, trusts and long term credit banks generally selected the buyback option. These banks chose the buyback option primarily to reduce their exposure in the Philippines. However, as explained earlier, because sovereign loans
constitute a very small percentage of the exposure of most Japanese banks, the capital cost of recognizing losses does not seem to be a major constraint for Japanese banks. At the same time, because Japanese banks are allowed to deduct small amounts of their exposure for tax purposes outside debt reduction operations, the opportunity to realize losses makes participation in debt reduction relatively more attractive for Japanese banks. The buyback option was selected by many banks for these reasons also.

PHILIPPINE DEBT - JAPAN

- DEBT ACCEPTED - $596MM
- DEBT REJECTED - $224MM
- NEW MONEY BASE- $1.18B

However, many large Japanese banks selected the new money option despite the opportunity to realize tax losses through the buyback option primarily due to business strategy reasons.

Japanese Banks - Interview Results: Four large Japanese banks were interviewed. The new money option was selected by these banks primarily because: (i) as a matter of business strategy, these banks wanted to maintain long term business relations with the Philippines; and (ii) due to Japan's geo-political interests in the Philippines, they felt obligated to continue to support the country through the new money process.

All four banks interviewed cited business strategy, client interest in the Philippines and Japan's geo-political interests as the dominant factors affecting their choice. One bank wished to minimize the loss on its Philippine claims and hence decided against the buyback option. Another bank was optimistic of Philippines' long term prospects. Yet another felt that if sufficient new money contributions were not forthcoming, Philippines' financing needs would have to be met through a club loan, and therefore it would end up contributing in any event.
Canadian Banks

As in the Mexican package, Canadian banks contributed no new money to the Philippine package and split their participation in debt reduction by offering their claims for buyback. Of these, 66% face value amount were accepted and 34% were rejected. From a tax and regulatory point of view the preference for debt reduction over new money is encouraged by the mandatory 35% provision required against loans to the Philippines. Also banks have already recognized significant capital losses on their existing assets and as a result would be required to recognize correspondingly less of a capital loss upon participation in debt reduction. From a tax point of view, the debt reduction operation resulted in no additional tax loss for Canadian banks. Their choices suggest that they considered the capital and other costs associated with making new money loans to be higher than the benefits of lower taxes and higher income associated with new money loans and tax deductible provisioning.

Canadian Banks- Interview Results: Two of the three banks interviewed had eliminated their Philippine exposure through secondary market operations prior to negotiation of the financing package. The third bank selected the buyback option primarily to avoid expensive provisioning on new money loans.
German Banks

Of the total exposure of U.K. banks in the Philippines, nearly 60% was offered for buyback. Many German banks apparently were discouraged from making new money loans by the mandatory provisioning requirement against new money loans. Moreover, German banks have already recognized significant capital losses on their existing assets and consequently would have been required to recognize correspondingly less of a capital loss upon participation in the buyback. From a tax point of view, the buyback resulted in little additional deductible losses, while new money lending created additional tax deductible provisions. To the extent that tax and regulatory factors influenced the choice of the buyback option, it appears that the capital and other costs of making new money loans outweighed the benefits of lower taxes and higher income associated with new money loans.
United Kingdom Banks

Of the total exposure of U.K. banks in the Philippines, nearly 55% was offered for buyback. Many U.K. banks were probably discouraged from making new money loans by the mandatory provisioning requirement against new money loans. Moreover, the uncertainty surrounding the tax deductibility of these mandatory provisions did not help in ameliorating the projected cost of new money loans.

United Kingdom Banks - Interview Results: The statements and views of the banks interviewed were broadly consistent with these reasons for the choice of instruments by the banks.

![Pie chart showing Philippine Debt - United Kingdom](chart.png)

- DEBT ACCEPTED - $219MM
- DEBT REJECTED - $56MM
- NEW MONEY BASE-$233MM
Costa Rican Financing Package

In the Costa Rican package, banks accounting for about half of the total commercial bank debt offered more than 60% of their exposure for buyback. Of the total debt 62% was repurchased, 19% was exchanged for Series A bonds and 19% for Series B bonds.

Both series A and B bonds were exchanged at par with existing loans. Series A bonds carried partial credit enhancement of interest and had more favorable terms from the banks' point of view (20 years maturity including 10 years of grace) than Series B bonds (which had a tenor of 25 years and 15 years of grace). Hence, Series A bonds were superior in economic terms to Series B bonds. However, only the banks offering more than 60% of their debt for buyback were eligible for Series A bonds.

One possible reason for the choice of B bonds by banks was that they did not want to extend large debt relief (81 cents per dollar face value of debt) and realize large losses on a major portion (more than 60%) of their Costa Rica portfolio.
French Banks

Of the total exposure of French banks exchanged for bonds, an overwhelming proportion (91%) was exchange for A bonds. This is indicative of the fact that a large majority of banks offered more than 60% of their debt for buyback. The banks generally wanted to reduce exposure in Costa Rica and used the buyback option as an exit vehicle. Due to the relatively small exposure of French banks in Costa Rica, the negative regulatory impact was small.

French Banks - Interview Results: The banks interviewed either selected the buyback option to reduce their exposure in Costa Rica or had already eliminated exposure through secondary market operations prior to the agreement.

United States Banks

In aggregate, U.S. banks exchanged 45% of their total exchanged exposure for Series A bonds and 55% for Series B bonds. For the U.S. banks, the loss incurred under the buyback did not have major regulatory and tax implications since these losses were written off against existing ATRRs which were excluded from regulatory capital and were tax deductible. Prior to the transaction, many banks had established ATRRs in excess of 60% of their Costa Rican exposure. To the extent, however, that the loss exceeded the ATRRs, it could be charged off against general reserves and then against income. Loss thus charged off however was tax deductible.

U.S. Banks - Interview Results: Four major banks were interviewed for the report. Three of the four banks selected the A bond and one bank selected the B bond. Two of the banks selecting the B bond said that tax and regulatory factors did not play a significant role in their choice of instruments. The decision was rather based on exposure management considerations. The banks were seemingly unprepared to extend large debt relief on a significant portion of their claims. The bank selecting the A bond had a specific interest in the success of the financing package and hence offered a substantial portion of its claims under the buyback.

Japanese Banks

Japanese banks generally selected the buyback option. The exposure of Japanese banks in Costa Rica was relatively small and they used the buyback option as an exit vehicle.

Canadian Banks

Canadian banks split their exposure exchanged for bonds roughly in half between Series A (51%) and Series B (49%) bonds. Many Canadian banks had substantial loan loss reserves which were tax deductible up to a maximum of 45%. Hence, whereas loss under the buyback in excess of reserves had to be charged off against income, loss in excess of 45% could be deducted for tax purposes. Many banks, however, limited the amount of debt offered for buyback to less than 60% apparently to control the amount of loss and manage their exposure in Costa Rica.

Canadian Banks - Interview Results: Of the three banks interviewed, two selected A bonds because they were interested in reducing their exposure in Costa Rica significantly and also because A bonds were economically superior. The third bank had eliminated its exposure in Costa Rica through market operations before the transaction and hence did not participate in the financing package.
United Kingdom Banks

The exposure of U.K. banks offered for bonds was fairly evenly divided between Series A and B bonds (52% and 48% respectively). Series A bonds were economically superior to the Series B bonds. Hence, banks would have automatically chosen the A bonds if they could afford to offer more than 60% of their debt for buyback. The choice of A and B bonds, therefore, depended on the tradeoff between the tax and regulatory costs of the losses on the buyback and the incremental value of the A bond vis-a-vis the B bond. The latter depended on the perceived quality of the banks' Costa Rica claims: the poorer the quality the higher was the relative value of the credit enhancement on the A bonds, and hence the higher was the incremental value of the A bonds, and vice versa. From the results of the transaction, it seems that about half the banks (in terms of exposure) placed greater weight on the latter factor and came out in favor of the A bonds, while the other half placed more weight on the former and hence favored the B bonds.

United Kingdom Banks - Interview Results: The banks interviewed generally supported the above analysis.

German Banks

Nearly all of the exposure of German banks exchanged for bonds (98%) was exchanged for Series B bonds. This implies that German banks by and large offered less than 60% of their exposure for the buyback. One possible reason for this behavior of German banks was that the perceived cost of losses from tax and regulatory standpoint was higher than the perceived incremental economic value of A bonds vis-a-vis the B bonds.
IV. CREDITOR COUNTRY ANALYSIS

In 1982 creditor bank governments responded to the developing country debt crisis by taking coordinated actions to protect the international banking system. While creditor bank governments had a common objective, the tax and regulatory policies used to accomplish this objective took different forms. Initially these differences were overshadowed by the need for a unified strategy towards the international debt crisis. As the need for a unified strategy has disappeared, greater differences in the regulation and taxation of sovereign loans have emerged. In most cases these differences reflect differences in underlying national approaches towards bank regulation and taxation. In a few cases governments have taken explicit steps to use tax and regulatory policy to encourage bank participation in financing packages. This section provides a very broad overview of the development of tax and regulatory policy towards sovereign debt since 1982.

In the United States, banking regulators took actions designed primarily to support the new money process, allowing the banking system time to recover. For example, regulators did not require banks to allocate large amounts of regulatory capital to developing country loans through the creation of specific reserves against existing claims or new money contributions. At the same time, the rule that loans 90 days overdue must be placed on nonaccrual and the periodic reviews of sovereign credits of the Interagency Country Exposure Review Committee (ICERC) held out the threat that if financing packages were not successfully negotiated, banks would not be allowed to recognize income and would eventually be forced to write down assets.

United States regulators also avoided taking action that would encourage banks to be imprudent in meeting country financing needs by assuring that banks continued to make positive decisions to lend rather than—for example—making use of interest capitalization. Forcing banks to take a positive decision to provide new loans helped to put some limits on the process. Interest capitalization might have made the financing decision a relatively passive one and, therefore, one that would have been difficult to control.

For reasons unrelated to the LDC debt-crisis, the United States disallowed the tax deductibility of “general” loan-loss provisions for “large” banks (i.e. banks with assets having an aggregate tax basis of more than $500 million). The ability to deduct such provisions was removed by the 1986 Tax Reform Act. This policy has meant that some United States commercial banks have a tax incentive to realize losses through secondary market sales or voluntary debt reduction operations. United States banks are allowed, however, to deduct specific provisions mandated by ICERC (ATRRs) from taxable income. Regulators have in general been reluctant to require such provisions. However, the number of countries to which ATRRs apply and the level of ATRRs have both been steadily increasing as the number of countries with protracted arrearages to commercial banks has increased. At this time no country has been removed from the list of countries for which ATRRs are required. The total amount of tax loss that has been recognized by United States commercial banks has increased as ATRRs have increased and more banks have sold or exchanged portions of their sovereign loan portfolios in either the secondary market or voluntary debt reduction operations. It should be noted that for banks with low profits and/or excess carryovers and tax credits there may be an incentive to push the recognition of tax losses into the future.

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1 As explained below, it is not clear that United States commercial banks can recognize tax losses by simply writing off loans. In order to be confident about the losses claimed, banks must—in the absence of an ATRR—realize losses by selling the loans in the secondary market or by participating in voluntary debt reduction operations.
While some United States banks may continue to have some incentive to realize tax losses, they, as mentioned above, do not necessarily have an incentive to do so through voluntary debt reduction. United States banks have alternative methods available to them for the realization of tax losses. They may realize such losses, for example, through sales in the secondary market and debt swaps. Such transactions do not necessarily pass any clear benefit to the debtor country.

In addition, loan charge-offs may provide an avenue for recognizing tax losses. U.S. banks are allowed to take a charge-off against general loan loss reserves in lieu of establishing ATRRs, in the year in which ATRRs are required to be established. Rev. Rul. 84-94 provides that, for federal income tax purposes, a bank may charge either the ATTR or the amount charged against the allowance for possible loan losses against its reserve for bad debts.

Initially, United States regulatory policy created an incentive framework which has discouraged interest capitalization and, to some extent, voluntary debt reduction. Interest capitalization is discouraged by regulatory policy which requires in essence a 100% specific reserve against capitalized interest. In contrast, no specific allocations of regulatory capital have been required in the case of new money loans. Voluntary debt reduction in some forms has been discouraged by the fact that banks in many cases would be required to recognize an upfront capital loss upon participation in some types of transactions. Since most United States bank loan loss reserves against LDC assets are general reserves (which are included in regulatory capital), provisioning has not decreased the capital loss that would have to be recognized upon participation in voluntary debt reduction. However, United States regulations, Financial Accounting Standards Board Statement No. 15 (FASB 15) in particular, have made it possible to structure debt reduction operations in such a way that an upfront capital loss need not be recognized. FASB 15 allows banks to delay the recognition of loss where banks have made a significant concession to the debtor and the undiscounted sum of expected payments is at least equal to the recorded investment in the receivable. The application of FASB 15 to international loans was a subject of some debate for the first six years of the debt crisis. That debate was largely resolved in 1989 by a letter from the Securities and Exchange Commission (SEC) to the U.S. Treasury which required banks to apply FASB 15 when certain conditions obtained.\(^2\)

The SEC letter to the United States Treasury was one of several important efforts by tax and regulatory officials in the United States to clarify the tax and regulatory treatment of sovereign debt. Many areas of uncertainty have been clarified, especially since the announcement of the Brady package in 1989. Among the areas of uncertainty that have been resolved are the tax and accounting treatment of bonds issued in voluntary debt reduction operations and the sourcing of tax losses from foreign loans. However, important areas of uncertainty remain. Among the most important areas of uncertainty are (i) the tax and regulatory treatment of some forms of interest capitalization, (ii) the application of ATRRs to credit enhanced instruments that have been accepted in the context of voluntary debt reduction operations and (iii) the tax treatment of loan charge-offs.

In Germany, authorities encouraged banks to increase their sovereign risk provisions by granting the tax deductibility of specific provisions against LDC risk. Given the relatively high tax rates in Germany (56% on undistributed profits), the tax deductibility of provisions provided a strong incentive for German banks to reserve against their LDC loans. As the amount of regulatory capital allocated to new money loans increased, the difference in the regulatory treatment of new money and arrears decreased. As time passed, German banks were, therefore, likely to find fewer regulatory benefits in making new money loans. At the inception of the debt crisis, the risk posed to the banking system was so severe that these provisions did little to

\(^2\) Although the letter is not binding upon banks, it does reflect the opinion of the SEC staff and, as a result, is treated by many practitioners as if it were binding by United States commercial banks.
discourage new money contributions. But, as the banking system recovered, the practice of allocating large amounts of regulatory capital to LDC assets in the form of specific provisions discouraged the new money process.

In the late 1980's, when a few new money packages were still being organized, some German banks reportedly showed a preference in favour of interest capitalization over new money. This may have been related to the fact that it was possible to establish higher tax deductible provisions against interest capitalization than against new money loans.

While German regulatory policy had the effect of removing some of the incentives for new money, the German tax treatment of provisions also removed tax incentives for German banks to dispose of their LDC assets. The result was that German banks may have had a disincentive both to grant new money loans and to dispose of assets on the secondary market or through debt reduction operations.

In the recent financing packages the effect of German tax and regulatory policy seems to be reflected in the fact that German banks have not chosen to contribute new money, with the exception of a small contribution in the Philippine package. Regulatory and tax policy also may create, as described above, some disincentives for German banks to participate in voluntary debt reduction. German banks have participated in recent debt reduction operations. It is difficult to tell whether or not their participation has been adversely impacted by German tax and regulatory policy.

The regulation of international debt in Germany has been effected by the German application of the Basle guidelines as discussed in the section on Germany below. Most recently guidelines for the calculation of capital adequacy have been substantially revised.

In Canada regulatory and tax policies in the initial stages of the debt crisis were clearly supportive of the new money process. Prior to 1984 banks had no provisioning requirements against their developing country claims and limited disclosure requirements. In 1986, the Inspector General of Banks issued guidelines for provisioning. Initial provision levels were quite low. Banks were required to create reserves against a list of thirty two countries in amounts between 10% and 15% of their exposure. Since 1986, the level required reserves has risen rapidly. Currently banks are required to create reserves of at least 35% of their exposure to an enlarged list of troubled debtors. As in Germany and the United Kingdom, reserves against developing country claims are excluded from regulatory capital. Although a 1987 change in tax policy limited the deductibility of general provisions, provisions against country risk have been treated as tax deductible in amounts up to 45% of the loan's face value. The reserve requirements against country risk have, as in Germany, probably discouraged new money. At the same time, granting the tax deductibility of provisions has reduced the incentive for banks to dispose of their assets.

In recent financing packages the effect of Canadian regulatory policy seems to be reflected in the fact that Canadian banks have not chosen to contribute new money.

In October 1990 the Office of the Superintendent of Financial Institutions (OSFI) issued a revised and comprehensive guideline on provisioning for country risk and accounting for debt reduction operations.

Initially France and the United Kingdom followed policies similar to those implemented in the United States which had the effect of supporting the new money process. But

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3 For some time, a maximum reserve level of 45% on sovereign loans. This cap was removed in 1990.
as banks in the United Kingdom began to improve their position, banking regulators began to move towards a system of specific reserving against LDC assets. This move culminated in 1987 with the issuance of the Bank of England (BOE) matrix for establishing specific provisions against LDC claims. In a break with earlier policies, the BOE also excluded these provisions from regulatory capital. Inland Revenue initially indicated that it would accept the matrix as a “basis” for determining the tax deductibility of provisions. However, the 1990 budget law contains a matrix very similar to the BOE matrix to be used for tax purposes. The matrix contains some limitations on the tax deductibility of provisions. U.K. banks are allowed to deduct provisions established according to the Inland Revenue matrix. Although these limitations were created for budgetary reasons they may create a small incentive for banks to dispose of their LDC assets through voluntary debt reduction operations or secondary market sales.

The United Kingdom policies initially had the impact of fully supporting the new money process. The introduction of matrix provisioning levels in 1987 reduced the attractiveness of new money to banks. Allowing the partial tax deductibility of provisions has also removed some potential incentives for U.K. banks to dispose of the LDC assets.

In France, banking authorities began requiring specific provisions in 1984 when the Commission Bancaire issued a “recommendation” outlining the standards for provisioning. Due to the weaker capitalization of the larger French banks, banking authorities allowed these specific provisions to be included in regulatory capital. In addition, banking authorities in France pushed for some key provisions in the Basle Agreement which would allow for more significant inclusion of loan loss reserves in capital in future years. The end result is that provisioning has been attractive for French banks, since it allows them to make, in essence, a tax free addition to their capital.

While this strategy has been an effective way of strengthening the French banking system, it has also made debt reduction relatively unattractive for French banks. This is because debt reduction in some forms would involve an upfront capital cost that would not be offset by a tax deduction since tax reductions are recognized when provisions are established. Tax deductibility of provisioning and inclusion in supplementary capital have also given French banks little of the regulatory incentives that United States banks have for participating in new money exercises, since the cost of arrears for French banks is lessened by the regulatory treatment of provisions. For United States banks, the cost of arrears is much greater due to the sharp difference between current and non-performing assets in the United States regulatory system.

The reluctance of French banks to engage in debt reduction is reflected in the fact that they have chosen to participate in recent financing packages by contributing new money more than any other national group of banks. However, even this contribution has been small.

In Japan, the effect of Ministry of Finance (MOF) policies with respect to LDC debt has been to encourage the new money process. Only small amounts of specific provisions have been required; banks have, in general, not been allowed to dispose of their LDC assets; and, the tax deductibility of losses on LDC loans has been limited outside of voluntary debt reduction operations. In the context of voluntary debt reduction operations, Japanese banks have been allowed to deduct their losses for tax purposes. Due to the relatively stringent tax policy implemented in Japan with respect to LDC debt, Japanese banks are influenced by the MOF rules on the deductibility of losses on sovereign debt from taxable income. If the tax deductibility of debt reduction is granted, Japanese banks are likely to participate in debt reduction, as they have done in many of the recent packages. On the other hand, if tax deductibility is not granted in a particular transaction, Japanese banks are likely to hold onto their existing assets. The case-by-case approach taken by the MOF towards LDC debt allows Japanese authorities somewhat greater
flexibility in providing incentives to banks to participate in particular types of transactions than may be possible in other countries.

The recently adopted Basle guidelines will eliminate, over time, many of the differences that exist in the regulatory treatment of loan loss reserves with respect to whether or not such reserves are included in regulatory capital. The Basle guidelines exclude loan loss reserves in excess of 1.5% of risk-weighted assets after year-end 1990 and 1.25% of risk-weighted assets after year-end 1992. This means that additions to loan loss reserves (for banks that already have high reserve levels) will increasingly be perceived as a capital loss. To the extent that the treatment of loan loss reserves in the Basle guidelines forces banks to allocate greater amounts of regulatory capital to their LDC assets and these new allocations are not accompanied by tax deductions, the progressive application new guidelines will continue to remove some of the disincentives to voluntary debt reduction that currently still seem to exist to some degree.

The body of this study attempts to give a more detailed description of tax and regulatory policies affecting the timing of tax and book loss recognition on LDC claims in the six countries studied. As stated above, the goal of the study is not to make policy recommendations in this complicated area but to provide a background description of regulatory and tax policies which govern the recognition of losses in the United States, Canada, France, Japan, the United Kingdom and Germany. In some cases, the way in which tax and regulatory policies will be applied to transactions is still unclear. In the near term, tax and regulatory regimes which impact lending to the highly indebted countries are likely to continue changing as a result of both the shifting nature of financial intermediation and the continuing evolution of tax and regulatory policies and as a result of new innovations in the market based menu. Many of the transactions that have been proposed or implemented in the context of the Brady initiative announced in 1989 were novel and, as a result, caused new regulatory and tax authorities to issue new guidance. This guidance continues to appear as new packages are signed and as tax and regulatory policies continue to evolve.
United Kingdom

The Bank of England (BOE) is the statutory supervisory authority of banks in the United Kingdom. In addition to obtaining information regarding a bank's financial status, the BOE exercises its responsibilities primarily through discussions with bank management. The U.K. Treasury and Inland Revenue are responsible for formulating and administering tax policies that effect the tax treatment of sovereign debt.

In 1987, the BOE established a country scoring system (the “matrix”) to determine for supervisory purposes the appropriate level of provisions against country risk. This scoring system was not intended to provide a strict and comprehensive codification of existing practice. Rather, it was intended to give banks a framework to assist them in arriving at an adequate provision level. Although the application of the matrix is not legally mandatory, the matrix is used by the BOE to establish minimum provision levels that banks are expected to maintain. According to the BOE Banking Act Report 1988/89, the BOE “has sought to ensure that banks carry at least the minimum level of provisions implied by the matrix.”

In 1987, the matrix resulted in an average provisioning level of about 25%. In 1989, the BOE issued a revised matrix which was adopted to “take account of two years' experience of the matrix's application in practice, and of the widespread perception that the situation among debtor countries had deteriorated significantly.” The revised matrix scoring system results in provisioning levels at an average of 50% against loans to troubled debtor countries. The differences between the original and revised matrices are discussed below.

The Inland Revenue’s approach to the tax deductibility of provisions has evolved since the onset of the international debt crisis in 1982. Until 1990 there were no provisions in the UK tax code dealing specifically with sovereign debts and claims for tax relief on provisions in respect of such debts had to be considered in the same way as claims in respect of any other commercial debt. In 1983 the Inland Revenue wrote to the British Bankers Association to offer guidance on the tax deductibility of provisions. This guidance was further clarified with the introduction of the matrix in 1987. At that time, the Inland Revenue agreed to accept the matrix as a starting point for determining the provisions allowable for tax purposes. Inland Revenue then entered into intensive discussions with, among others, the British Bankers Association to achieve a more uniform and predictable approach to the problem. To provide greater certainty about allowable provision levels, and to control the potential tax cost of further increases in banks' provision levels, specific legislation was passed in 1990 which detailed the appropriate treatment of provisions for tax purposes. In this respect the 1990 Finance Act has clarified the general principles that are to govern the tax deductibility of losses on loans to developing country debtors. The Finance Act requires banks to apply a matrix that, with a few exceptions, is similar to the BOE matrix. Furthermore, the Finance Act introduces a limitation on tax deductibility of losses that applies to tax losses claimed outside of the context of a developing country debt reduction operation. The limitation was designed to spread revenue losses associated with the tax deductibility of provisioning over a number of years. This limitation may, as a side effect, also create a small incentive for banks to participate in voluntary debt reduction operations.

4 The language of the August 1987 letter to UK banking institutions is instructive in this regard. In the letter, to which the BOE matrix was attached, banks “which had exposures to countries experiencing debt repayment and servicing difficulties” were “encouraged” (emphasis added) to “reconsider the adequacy of their provisions against exposures to such countries.” The letter does not state that banks are required to apply the matrix in determining appropriate provision levels.
In addition to the guidance issued with respect to provisioning, the BOE has provided informal guidance on the appropriate treatment of some forms of voluntary debt reduction.

While large areas of uncertainty with respect to the tax and regulatory treatment of sovereign debt have been removed, some issues remain uncertain. The tax and regulatory treatment of interest capitalization is an example of such an issue. As is often the case, such issues are likely to be clarified as the UK banking auditors and, to a lesser extent, the BOE staff are presented with the need to comment on specific transactions.

In general, representatives of U.K. commercial banks have become more pessimistic about repayment prospects and the restoration of country creditworthiness. This pessimism is reflected in the fact that large commercial banks in the U.K. increased their reserves against developing country debt in 1990 to over 50% of their medium- and long-term exposure.

Institutional Framework

The Banking Act of 1979 imposed on the BOE the primary statutory responsibility for regulating and supervising commercial banking activities and for this purpose established two categories of institutions: (1) recognized banks for which supervision emphasizes frequent and extensive discussions with the senior management of the banks; and (2) licensed deposit takers for which the BOE adopts more formal regulatory procedures. The Banking Act of 1979 has now been replaced by the Banking Act of 1987 which creates only one category of bank. The Banking Act of 1987 also introduced the concept of reporting accountants who report on the prudential returns and the bank's systems and controls. In addition to obtaining regular information regarding a bank's financial status the Bank of England now exercises its responsibilities through discussions with bank management and through asking bank management to commission reports on systems and controls from those reporting accountants. The Bank of England obtains regular and detailed information on balance sheets, profit and loss accounts, and loan concentration. Regarding supervision of international lending, country risk exposure is monitored on a fully consolidated basis every six months. The BOE's regulatory philosophy reflects the idea that each bank should be treated on an individual basis. This philosophy is exemplified by the fact that there traditionally was no minimum capital ratio applicable to all banks. Instead, each bank was set an individual target ratio which it was expected to meet and a (lower) target ratio which it should not fall below at any time. The regulation of capital/asset ratios has now come into line with the Basle guidelines which will be fully applicable at the end of 1992.

The Companies Acts are the main legislative source of accounting rules. The rules will undergo substantial changes as a result of the implementation of the EC Bank Accounts Directive (86/635/EEC). The main nonlegislative source of accounting rules in the United Kingdom are the committees of the professional accounting bodies. In addition the British Bankers Association (BBA) and the Irish Bankers Federation (IBF) are currently drafting further guidance on specific topics in the form of non-mandatory Statements of Recommended Practice. For example, such a Statement on Recommended Practice dealing with the accounting for securities was recently issued jointly by the BBA and the IBF.

Disclosure Guidelines

Consistent with the general independence granted to United Kingdom banks, the BOE does not set formal limits or standards for lending to particular countries. It does, however, collect and analyze information which enables it to form an independent judgement about the risks of lending to particular countries. Country exposure of banks under its supervision is monitored on a fully consolidated basis. Banks are required to submit monthly summary returns and more
borrower type (i.e. industrial sector, agricultural sector, etc.), country of borrower and maturity. This information is used as the basis of an independent assessment by the BOE of a bank's international loan portfolio. While aggregate country risk exposure information is published four times a year by the BOE, information on the country risk exposure of individual banks is usually not made available to the public. However, this information is often available in the reports of major private credit analysts.

Paragraph 53 of a "Notice to Institutions Authorized Under the Banking Act of 1987" regarding "Large Exposures Undertaken" by such institutions states:

The Bank (BOE) does not believe that a common guideline exposure limit should be applied to banks' exposures to countries; nor does it consider it appropriate to publish guideline percentages for the acceptable level of exposure to particular countries. Banks will, however, be expected to set limits for country exposures on the basis of their own risk assessments. The nature of the exposure (for example, whether it is trade finance or longer term balance of payments finance) will be relevant in considering an acceptable level of exposure. The Bank will continue to monitor closely banks' country risk exposures, and discuss them with banks' managements. Banks and banking groups will continue to be required to report their country exposures to the Bank. Branches of overseas banks will also be required to report separately any exposure to central governments which exceed 10% of their capital base.

There are no specific accounting and disclosure requirements for sovereign loans other than the confidential information given to the BOE noted above. Sovereign loans are included in the balance sheet with other loans and advances and, where appropriate, provision is made for any potential loss. Accumulated provisions are deducted from loans.

Nonaccrual Loans

There are no authoritative accounting pronouncements requiring the disclosure of information on past due loans.

There are also no authoritative accounting pronouncements regarding the recognition of interest income on past due loans. This situation may be affected by the forthcoming publication of the Statement of Recommended Practice on Advances. But at the time of writing this report, the Statement of Recommended Practice on Advances had not been published. In practice, banks continue to take interest into income until the normal banking relationship has ceased, i.e., when the bank has ceased discussions with the borrower and has initiated legal proceeding against the debtor. This applies to all forms of lending. Appropriate specific provisions are made against interest receivable if there is a possibility that it will not be recovered.

Banks describe their policies for recognizing income in their financial statements. Most banks state that interest on advances, up until the normal banking relationship with the customer has ceased, is credited to the profit and loss account and provision is made where appropriate. There are no differences in the treatment of sovereign loans. Interest not recognized is not quantified.

There are no regulations, accounting policies or disclosure requirements for past due loans except for the fundamental and overriding accounting requirement that accounts must present a true and fair view. U.K. banks are not able to rely upon explicit regulations (as they are more likely to be able to do in the U.S. system, for example) but are required by statute to give a true and fair view of the state of affairs and results for the period.
There is also no authoritative literature and no generally accepted accounting practice for recording and disclosing debt restructuring.

**Bank of England Matrix: Regulatory and Accounting Guidelines for Loan Loss Reserves**

United Kingdom banks establish general and specific provisions against loan loss. A provision is normally set aside for any liability or loss which is likely to be incurred, but which may be uncertain as to timing and amount. Provisions which arise out of the impairment in value of an asset will normally be netted against that asset on the balance sheet. Other provisions will be shown as liabilities or may be separately disclosed. General loan-loss provisions are normally not deductible from taxable income and are included in regulatory capital. Specific provisions may be deductible from taxable income and are not included in regulatory capital. Provisions against country risk are specific provisions which are excluded from regulatory capital and which are established according to the guidance contained in the country scoring system developed by the BOE in 1987 and revised in 1989. This system is described and analyzed below.

In the United Kingdom, country-specific provisions are established according to a "matrix" which was developed and implemented by the BOE. The matrix marked a break with earlier reserving policies which contained no explicit guidelines for reserving against loans to troubled debtor countries. Since 1987 the BOE "has sought to ensure that banks carry at least the minimum level of provisions implied by the matrix."5 Although the matrix is not legally binding on banks and not officially mandatory, most U.K. commercial banks perceive the matrix as establishing a mandatory minimum of provisioning. The matrix provisions are not mandatory for branch operations. The main features of the BOE matrix are as follows:

- The application of the matrix or country scoring system to individual countries establishes a range within which provisioning levels should fall. Within this range, banks have discretion in determining what the appropriate level of provisions should be. The matrix takes into account evidence of debt servicing difficulties (rescheduling, arrears) and the likelihood that difficulties will be overcome as indicated by some criteria in terms of conventional debt ratios (e.g. debt_exports, interest_exports, debt_GDP and import cover).

- The provisions established according to the matrix criteria are excluded from regulatory capital. This practice marked a break from the BOE's earlier policy of including specific and general provisions in regulatory capital.

- The matrix is not intended to apply rigidly to all types of credit. The BOE considers that the matrix does not apply to categories of credit which in particular cases exhibit superior performance. Short-term trade credits are a frequently mentioned example of this type.

In 1990 the BOE issued a revised matrix for calculating indicated reserve levels (see Annex 1). The revised matrix replaces the earlier version that was issued in August 1987. According to the BOE's annual Banking Act report the revised matrix was adopted to "take account of two years' experience of [the matrix's] application in practice, and of the widespread perception in the market place that the situation among debtor countries had deteriorated significantly."

Among the most important indicators of deteriorating confidence in debtor country repayment ability was the action of the big four clearing banks to raise their level of reserves from 30-35% at

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end-1988, first to around 50% and later, in some cases, up to 70% of their exposure to troubled debtors. Similar moves took place in other countries. The matrix was, in part, designed to increase indicated reserves to levels closer to those provided for by the large U.K. banks. Among the changes that the revised matrix institutes are the following.

First, the matrix increases the level of indicated reserves to just under 50%. This roughly doubles the indicated reserves from that required by the original matrix issued in 1987.

Second, the matrix may increase slightly the relative importance of economic indicators in calculating recommended reserve levels. As in the earlier matrix, countries receive points according to their history of default and according to certain economic indicators, such as interest service/exports, import cover, debt/GDP and debt/exports. In the 1987 matrix a minimum score of 10 for category A and B factors (evidencing actual default) was required before the question of provisioning arose; provisioning could not be triggered by category C (economic) factors alone. The revised matrix eliminates the earlier distinction between points scored as a result of defaults and those scored achieved solely as a result of the economic indicators. In guidance issued to UK incorporated authorized institutions the BOE states that it is "right that indicators which provide evidence about the likelihood of debt repayment difficulties in the future, even without actual default, should be capable of triggering provisioning; therefore, while the minimum score of 10 remains, it now applies regardless of the source."\(^{6}\)

However, it should be pointed out that this change is of limited significance for at least two reasons. First, in the original matrix there was a relatively low cap on the total number of points that could be scored solely as a result of economic indicators.\(^{7}\) As a result of this limit the maximum provision level that could have been achieved solely as a result of economic indicators was relatively low. Secondly, in its annual report the BOE also states that "a score just above the minimum which is attributable to economic factors rather than to a default, although it should prompt a bank to consider the need for provisions, may not always lead to provisions being required." The BOE indicates in its annual report, as it has in other contexts since the publication of the matrix, that it will consider the use of economic factors (vs. actual events of default) in establishing provisioning requirements at low score levels on a case-by-case basis.

The revised matrix has been criticized because the greater emphasis on economic indicators could result in provisions being required against claims on countries that are generally considered to be creditworthy. Turkey and Australia were mentioned by some commentators as examples of countries against which provisions could technically be required. The BOE has discouraged such a legalistic interpretation of the matrix results and has argued that the matrix results are only an indication and should not be treated as mandatory provision levels. In addition the BOE has suggested informally that the view that provisions were recommended by the matrix against these countries was mistaken. The authors' own calculations suggest that this may indeed be the case.

Third, the matrix institutes a slightly more gradual increase in reserve levels and a somewhat finer grained scoring system which contains eight reserve level bands compared to the five bands that existed in the original matrix. For example, in the revised matrix a score of 10 requires a provision level of a maximum of 15% where the earlier matrix would have required a maximum of 13%. In the revised matrix the maximum number of points that can be achieved by a

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\(^{7}\) In the old matrix, it was possible to score a maximum of 32 on the economic indicators or "C" factors in the original matrix. Adding 32 in C Factors and 9 in A and B meant that the maximum possible score without getting 10 in A and B was 41, which would produce 25% provisions.
country has increased from 83 to 145. In order to achieve this higher maximum score, the BOE increased the scores imposed for many factors. According to the BOE, “the scoring ranges for a number of factors have been extended, to score more heavily those countries with deep seated payment difficulties; and there are refinements to some of the definitions.”

Fourth, there are some additional changes in factor analysis. For example, one new factor has been added to the matrix. According to the BOE, the new factor is “designed to penalize countries which are able to clear interest arrears only by capitalization or by advances of new money.”

Fifth, a smoothing technique has been introduced to avoid sharp fluctuations in the country scores which “might exaggerate an underlying change in the position of a debtor country”. This technique was introduced in response to the BOE perception that the matrix scoring system sometimes would show sudden changes in country risk without any real change having taken place. The use of a moving average reduces the risk of abrupt discontinuities in provisioning requirements.

The Case-by-Case Approach

Like the original matrix, the revised matrix takes a case-by-case approach to the exclusion of different types of assets from the basket for the purposes of calculating indicated provisions. Where a party can show that a type of credit has significantly higher probability of repayment than other credits to the country, the BOE may treat the credit differently. This is true, for example, with respect to most short-term trade and inter-bank credits. With respect to trade credits the BOE states in its annual report that:

“past evidence may show that some types of trade finance are reasonably certain to be recoverable in full. Where this is the case, the Bank recognizes that it may be inappropriate for such claims to be included in the total exposure against which the matrix is to be applied. At the same time, the Bank has resisted the release of provisions purely in response to an improvement in the matrix score, which may be short term. For instance, there may be doubt whether a country which has recommenced interest payments following a rescheduling agreement will be able to continue them.”

The BOE has also indicated that more favorable treatment may be available to some credits which have the appropriate type of participation of an official agency or an international financial organization. For example, the BOE has agreed to exclude loans with IFC sub-participation from the matrix calculations. However, the participation of an international financial institution in no way assures more favorable treatment. The BOE will look carefully at the details of every type of transaction. For example, the treatment of loans with IFC sub-participation is more favorable than the BOE’s treatment of IBRD co-financing (parallel lending) where the matrix has been applied in the usual way. The BOE has justified this distinction on the grounds that in the former case the IFC remains the lender of record.

Table 1 shows our estimates of the required level of provisions as calculated by the revised matrix. It should be strongly emphasized that these calculations are only the authors’ estimates and in no way represent the views of the World Bank or the Bank of England.

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### TABLE 1

Estimated Provisioning Requirements as Indicated by the Revised Matrix as of 1/1/91

<table>
<thead>
<tr>
<th>Total Score</th>
<th>ARGENTINA</th>
<th>BOLIVIA</th>
<th>BRAZIL</th>
<th>CHILE</th>
<th>COLOMBIA</th>
<th>COSTA RICA</th>
<th>IVORY COAST</th>
<th>ECUADOR</th>
<th>JAMAICA</th>
<th>MEXICO</th>
<th>MOROCCO</th>
<th>NIGERIA</th>
<th>PERU</th>
<th>PHILIPPINES</th>
<th>URUGUAY</th>
<th>VENEZUELA</th>
<th>YUGOSLAVIA</th>
</tr>
</thead>
<tbody>
<tr>
<td>100%</td>
<td>8 12 12 0 8 8 10 3 5 5 7 3 2 8 0 4 87 76-89</td>
<td>12 12 12 12 10 3 5 7 7 0 0 8 0 1 89 76-89</td>
<td>12 12 12 0 8 8 10 3 3 0 5 0 2 8 0 3 74 70-84</td>
<td>0 6 6 0 0 0 8 3 3 3 0 0 0 2 2 1 34 40-54</td>
<td>0 0 0 0 0 0 3 3 0 3 0 2 2 0 2 15 25-39</td>
<td>0 12 12 0 0 0 10 0 5 5 3 0 0 4* 0 2 49 24-37</td>
<td>8 12 12 0 8 8 10 0 10 10 7 0 2 12 2 4 97 85-99</td>
<td>8 12 12 0 8 8 10 0 5 7 5 3 2 8 2 4 86 76-89</td>
<td>2 12 12 0 2 2 10 0 3 7 0 0 2 4 2 3 59 38-58</td>
<td>0 12 12 0 0 0 10 3 3 3 3 0 0 4* 2 1 53 55-69</td>
<td>8 12 12 0 8 8 10 3 3 5 3 0 2 4 0 3 73 59-75</td>
<td>8 12 12 0 8 8 10 3 3 7 5 0 2 8 2 3 83 59-75</td>
<td>12 12 12 15 12 12 10 0 3 3 7 3 2 12 0 4 107 90-96</td>
<td>2 12 12 0 2 2 10 3 3 3 3 3 2 2 0 3 60 38-58</td>
<td>2 12 12 0 2 2 10 3 3 3 0 0 0 2 4 0 3 53 24-37</td>
<td>0 12 12 0 0 0 10 3 3 3 3 0 0 4 2 1 53 24-37</td>
<td>0 12 12 0 0 0 10 0 3 0 0 3 2 4 0 3 49 24-37</td>
</tr>
</tbody>
</table>

* This score reflects the secondary market price of debt instruments issued in the context of recent restructurings. However, as shown in Table 2, the level of required provisions is now below the actual provisions of a number of large U.K. banks as of January 1991. This fact, combined with the tax treatment of provisions described below, indicates that U.K. banks may have a tax incentive to dispose of the sovereign loans against which provisions have been established.

### TABLE 2

<table>
<thead>
<tr>
<th>Bank</th>
<th>Reserve Level</th>
</tr>
</thead>
<tbody>
<tr>
<td>Barclays</td>
<td>70%</td>
</tr>
<tr>
<td>National Westminster</td>
<td>75%</td>
</tr>
<tr>
<td>Midland</td>
<td>50%</td>
</tr>
<tr>
<td>Lloyds</td>
<td>70%</td>
</tr>
<tr>
<td>Standard Chartered</td>
<td>62%</td>
</tr>
</tbody>
</table>

*Source: Press reports*

The BOE has also issued some guidance with respect to the regulatory treatment of debt reduction instruments. This guidance is described below in the context of discussing particular instruments.
Tax Issues

Section 74(j) of the Income Corporation and Taxes Act 1988 allows for the deduction of "bad debts proved to be such, and doubtful debts to the extent that they are estimated to be bad". However, the Tax Act provides no guidance for determining when a loan should be deemed "bad" or "doubtful". Past decisions of the tax courts provide useful precedents in the commercial context, but tax disputes related to the deduction of losses claimed on sovereign loans have not been adjudicated.

The Inland Revenue's approach to the problem has evolved since 1982. Until 1990 there were no provisions in the UK tax code dealing specifically with sovereign debts, and claims for tax relief on provisions in respect of such debts had to be considered in the same way as claims in respect of any other commercial debt. Section 74(j) required the creditor to estimate, on a debt-by-debt basis, the extent to which the debt was likely to prove bad. Relief is not available for general provisions. The relevant test is the extent to which the debt is likely to be ultimately irrecoverable, so that a delay in repayment of capital or a failure to pay interest would not be conclusive factors.

Decided cases provide direct guidance in determining how far a sovereign debt may be regarded as bad, and the Inland Revenue offered no precise guidance. However in January 1983 it wrote to the British Bankers Association to set out its general approach (Annex 2).

The letter stated the general principles that Inland Revenue believed should determine the tax deductibility of provisions on sovereign loans. The main principles outlined in the letter were:

(i) Individual banks should decide what they consider to be appropriate provisions for tax purposes.

(ii) The deductibility of such provisions would be determined in light of "relevant tax law" and the "particular circumstances" of the debt.

(iii) Rescheduling of debts does not preclude the establishment of tax allowable provisions.

(iv) Overdue interest might be provisioned against.

(v) Provisions are subject to annual review.

(vi) In assessing repayment probabilities exchange controls should be taken into account.

The letter left the important issues unresolved because the relevant tax law to which the letter referred did not specifically refer to sovereign debt situations in which it was not clear how to apply the usual approach to bad debts.

The Inland Revenue further clarified its position when the Bank of England introduced the matrix for provisioning in August of 1987. As described above, the matrix was intended to provide guidance to banks with respect to the minimum provision levels that would be considered prudent for regulatory purposes. The Inland Revenue agreed to accept the matrix as a starting point for determining the provisions allowable for tax purposes. However, the Inland Revenue also drew attention to the fact that the BOE matrix was not established for tax purposes.
The Inland Revenue was also unsatisfied with the wide range of provision levels that could be consistent with a particular score in the matrix.

After the introduction of the matrix, the Inland Revenue entered into detailed discussions with the British Bankers Association and other bank representatives on how the matrix should be applied for tax purposes. The Inland Revenue advocated what became known as the "direct read-across" approach i.e. that a score on the BOE matrix be associated with precise provision level for tax purposes. It appeared to some observers that the issue would ultimately be resolved by banks appealing the Inland Revenue's tax assessment to the relevant appellate body, the Commissioners for Income Tax and its superior courts.

During this period of negotiation and uncertainty, individual tax inspectors were left with discretion in determining the exact deduction. In practice, informal conversations with tax practitioners in the U.K. suggest that banks (on average) were allowed to deduct the minimum provisions indicated by the BOE matrix minus seven percentage points. For example, if the minimum indicated provision level was 45%, a bank would have been allowed (on average) to deduct an amount equal to 38% of the face value of the debt.9

To provide greater certainty about allowable provision levels, and to control the potential tax cost of further increases in banks' provision levels, the U.K. government decided to introduce specific legislation in 1990 on sovereign debts. Two relevant pieces of legislation have been enacted into law. The first, the Finance Act, inserts new provisions into the Taxes Act (section 74 Finance Act 1990). This legislation was enacted as Section 74 Finance Act 1990 on July 26, 1990. The second piece of legislation sets out the mechanics of the computation to be used to determine tax allowable provisions. This legislation takes the form of regulations written by the Treasury and approved by a resolution of the House of Commons. The regulations are referred to as the Debts of Overseas Governments (Determination of Relevant Percentage) Regulation 1990. Draft regulations pursuant to the above legislation were published October 16, 1990 and adopted without significant changes by the House of Commons on December 4, 1990. The relevant portions of both of the above pieces of legislation are contained in the Annexes to this section.

As described above the Inland Revenue had indicated in 1987 that they were prepared to accept the matrix as relevant evidence under existing law. However, the BOE matrix only provided broad bands within which provisions for a country might be expected to fall and in any case was only guidance, intended for prudential rather than fiscal purposes, with no statutory force. The Debts of Overseas Governments Regulations 1990 were designed to follow the broad approach of the BOE matrix to scoring different factors, but the regulations provide a table allocating specific maximum provision levels to particular scores. This approach provides a firmer basis for calculating tax relief in future years.10

The basic elements of the Finance Act are described below:

The Finance Act applies to debt "which is owed by an overseas State authority or payment of which is guaranteed by an overseas State authority or which is estimated to be bad for the purposes of section 74(j) wholly or mainly because due payment is or may be prevented, restricted or subjected to conditions - (i) by virtue of any law of a State or other territory outside the United Kingdom or any act of an overseas State authority or (ii) under any agreement entered into

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9 It should be noted, however, that this was never considered to be an Inland Revenue position, informal or otherwise. The seven percent figure described in the text is the average result of individual inspectors. The amount of variation in the practices of individual tax inspectors is unknown.

in consequence or anticipation of such a law or act." 11 It does not apply to "interest on a debt or
to a debt which represents the consideration for the provision of goods or services." 12 The
legislation states that a "base percentage," representing the extent to which a debt is estimated to be
bad (i.e. the taxpayer's basis in the existing loan), is to be determined according to accompanying
Debts of Overseas Governments Regulations 1990. The base percentage is determined as of the
end of the "base period" which is the last period of account of the company ending before 20th
March 1990. At the end of each succeeding year a "relevant percentage" must be established,
according to which additional deductions will be allowed. The tax relief for 1990 is frozen at the
1989 level, and thereafter any increase in the relevant percentage will be allowed at the rate of not
more than 5% per year.

The Finance Act limits tax relief for losses on the disposal of debt. Relief in each
year on the disposal of any particular debt may not exceed 5% of the face value of the debt except
in the first year when relief may not exceed 5% of the face value of debt over and above the
existing provisions against the debt. For example, if the level of provisions before 20th March
1990 is, say 35% for a bank, and an addition of 10% is made during 1990 such that the total
provisions are 45%, then at the end of 1990 the allowed relevant percentage would be up to 40%
(i.e. 35% plus the maximum 5% allowed each year) rather than 45%. This limitation does not
apply if the debt is disposed of directly to "an overseas State authority." 13 Banks that elect to sell
their debt into the secondary market would also be subject to the cap on additional deductions of
5% of the face value of the loan unless they sell their debt (or otherwise transfer it) to the debtor
country. If the debt is sold in the context of a debt reduction operation banks would be allowed to
deduct the full loss realized. This discrimination between sales in the context of debt reduction
operations and other sales may create a small incentive for banks to participate in debt reduction
operations in order to capture larger tax losses. However, an incentive would only be created to
the extent that losses that could be realized on the sale of debt are greater than the existing level of
tax allowable provisions.

The Debts of Overseas Governments Regulations 1990 regulations describe in
detail how the "relevant" percentage is to be determined. The regulations broadly follow the most
recent version of the Bank of England guidelines, with the omission of some of the more
subjective factors. Unlike the range of provision levels indicated by the Bank of England matrix,
the tax regulations provide for the calculation of a specific percentage as a tax provision. The
process incorporates a five quarter moving average, as does the BOE matrix.

The Annexes to this section contain Section 74 of the Finance Act and Debts of
Overseas Governments (Determination of the Relevant Percentage) Regulations 1990. The
annexes also contain the Inland Revenue press releases of March 20 and October 16, 1990. The
March 20 press release describes, in simple terms, the Chancellor's initial proposal in his Budget
to introduce changes to the system of tax relief for doubtful sovereign debt. The press release also
describes some of the rationale for the changes in tax policy towards sovereign debt.

**Tax and Regulatory Treatment of Specific Instruments**

In discussing the regulatory treatment of specific instruments it is important to keep
in mind the distinction between instruments which are held in trading portfolios and those which
are held in investment portfolios. Where instruments are held in trading portfolios the
recommended accounting and regulatory treatment is to "mark to market". Where instruments are

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11 Section 74, Finance Act, 1990.
12 Ibid.
13 The definition of "overseas state authority" that is used here is the same as that used in defining the type of debt to which
section 74 applies.
held in investment portfolios it is recommended that they be valued at cost and adjusted where
necessary for the amortization of premiums and discounts to redemption.14 Normally the
distinction between instruments held for trading and those held for investments purposes is based
upon the fact that instruments in the investment portfolio are held with the intention of holding
them for the long term, usually until maturity. In some cases, the distinction may be based upon
the type of instrument. For example, loan and deposit instruments are almost always treated as
investments for accounting and regulatory purposes.15 The discussion below of the accounting
and regulatory treatment for different instruments is mostly applicable to instruments held for
investment purposes. In the case of discount and par bonds, for exam, we assume that banks
always have the option of marking these instruments to market and holding them in the trading
portfolio.

Discount Bonds

The BOE issued guidance for the treatment of the discount bonds in the context of
the Mexican Brady package. In the context of this operation, the BOE stated that the discount
bond should be placed on bank books at its face value (i.e. 65 cents for every $1 of Mexican
debt). The difference between the original face value of the loan exchanged and the face value of
the new bond received is charged to provisions. An additional charge to income would only be
required if the loss exceeds provisions allocated to the loans exchanged. If the existing provisions
cover the loss, no additional provisions would be required. As in the case of the Aztec bonds, the
BOE has stated that no additional provisions would be required against the discount bonds, though
if the economic situation in Mexico deteriorates, new provisions might be required in line with the
matrix.

The Inland Revenue has taken the position that negotiable securities are not to be
treated as loans for tax purposes. In the case of discount bonds, the discount bonds would be
booked (for tax purposes) at their face value. Banks would be allowed to deduct the difference
between the face value of the original loan and the face value of the discount bond. This deduction
would be reduced to the extent that tax relief had already been granted for established provisions.

Par Bonds

In the case of the par bond, banks may record the bond at its face value. If the
provisions against the original loan were adequate, no additional provisions need to be made
against the par bond, unless there is further deterioration in Mexican debt. Banks would be
required to maintain a constant level of provisions. As the collateral grows, the unguaranteed
portion of the loan becomes smaller and the provision may be released into income. But the
precise timing of the reversal of provisions will depend upon (i) the specific form of credit
enhancement which the bonds carry and (ii) the approach of bank auditors with respect to the
release of provisions against credit enhanced instruments. The BOE has indicated that the release
of provisions over time consequent on the appreciation of the collateral can occur in line with the
bank's chosen accounting treatment.

The tax treatment of the par bonds with a reduced rate of interest is more
complicated. The Inland Revenue's position is that they should be booked at face value, less a
provision calculated on the basis of the net present value of the funding cost over the life of the
bond. The provision would be written back into income over the life of the bond. Although the
Inland Revenue has mandated no method for determining how funding costs should be calculated

14 Statement of Recommendation Accounting Practice, Securities. British Bankers Association and Irish Bankers
Association, September 1990.
15 Ibid., p. 3. Deposit and loan instruments, though capable of being bought and sold, are not in practice generally traded.
or how the provision should be written back, the method used by each bank is subject to the Inland Revenue's review and approval. The method used may be quite complicated in the case of instruments such as the Venezuelan bonds. Any tax relief granted would be reduced by the relief already given with respect to existing loans.

It is not clear, a priori, which bond would provide the greatest tax relief. In theory, the tax relief should be identical. However, in practice there may be differences due to a difference in the results of the funding cost calculation that must be used to calculate tax relief in the case of the par bond. From a tax point of view, the only real disincentive to accepting the par bond may be the relative complexity of the method needed to calculate tax relief.

**Buyback**

The regulatory treatment of a buyback is straightforward. The difference between the cash received and the face value of the original loan is charged to provisions. An additional charge to income is only necessary if this difference is greater than the existing provision level. The tax treatment also should be straightforward: banks should receive a loss equal to the difference between their existing basis and the value of the cash realized.

The tax treatment of some transactions may be complicated by the provision of the 1990 Finance Act which discriminates (for tax purposes) between loan sales into the secondary market and sales directly to the debtor country. If a transaction is treated as a sale to the debtor country, the tax treatment would be as described above: the tax basis in the original loan would be subtracted from the value of the cash received to arrive at the taxable gain or loss realized on the transaction. But if the transaction is treated as a loan sale into the secondary market, it would receive less generous treatment: the ability of banks to deduct losses in such transactions would be limited to the levels allowed for provisions according to the Inland Revenue matrix and would be subject to the 5% annual cap as described above.

As long as buybacks are straightforward transactions between a bank and the debtor these complications will not arise. Such complications might, however, arise if a transaction involves a third party. For example, if a bank sells its debt to another entity which subsequently sells the debt to the debtor country in a debt/equity or debt/nature swap, the bank may be limited in the deduction that it could realize on such a sale.

**New Money**

The Inland Revenue's matrix must be applied to determine tax allowable provisions. The BOE matrix must be applied to determine the provision indicated for regulatory purposes. The principles governing the application of the BOE matrix are identical to those governing the application of the matrix to existing credits.

**Interest Capitalization**

The Inland Revenue has not issued guidance rulings with regard to tax treatment of arrears or assets transferred in lieu of arrears. The regulatory treatment would follow the accounting treatment which would be determined by UK bank auditors. The BOE is likely to rely upon auditors to formulate the correct treatment of interest capitalization. This issue may be clarified by the forthcoming publication by the British Banker's association of a Statement of Recommended Practice on Advances. Although this Statement of Recommended Practice is not a BOE document it is likely to provide an important of reference for supervisors on most of the issues it addresses. The following treatment of interest capitalization seems consistent with existing accounting principles.
While interest arrears remain outstanding banks are expected to maintain a 100% provision against the amount of the arrears. This provision would be allowed for tax purposes. However, if the arrears are subsequently capitalized or otherwise refinanced as part of a debt restructuring agreement, the normal matrix-indicated level of provisions would apply. This provision would be allowed for tax purposes according to the Inland Revenue matrix.

Interest capitalization was a component of the recent Costa Rican debt reduction operation. In the context of this package, a portion of the past due interest was capitalized and repaid to creditors over a 15-year period at a rate LIBOR + 13/16. In addition, the agreement called for interest collateral of at least 36 months on that facility for those banks that tender 60% or more of their claims for the cash buyback.

According to existing rules, banks should establish the level of reserves against this claim that are indicated by the BOE matrix. Because banks previously had a 100% reserve against the arrears, they would be allowed to release reserves to the extent that the matrix indicated reserves at a level of less than 100%. For tax purposes, banks would probably be required to recalculate the indicated deduction according to the new Inland Revenue matrix. To the extent that this calculation yields a deduction smaller than the size of the claim (100% of which was deducted from income), they would be taxed. For example, if the matrix calculation yields a tax allowable provision equal to 60% of the face value of the claim, banks would be taxed on the remaining 40% of the claim which should be recognized as taxable income.

However, the tax consequences, as always, are likely to depend upon the specific facts of the transaction. If the interest is paid and then reinvested in bonds, the interest would be taxable and the provision in respect of the interest would be written back into profit for tax purposes. A provision in respect of the bonds would be allowed in accordance with the Treasury matrix.

If the unpaid interest is exchanged for bonds, then the bonds would be treated as taxable in respect of an amount equal to the value of the bonds in lieu of interest and the interest "lost" would be written off against the provision. This loss would not be subject to the 5% spreading provisions in the Finance Act. If the value of the bonds subsequently fell below the value attributed to them for the purposes of the exchange, a further provision may be allowed in accordance with the Inland Revenue matrix. The tax treatment of interest capitalization may discourage some U.K. banks from participating in transactions that would require the capitalization of significant interest arrears.

**Interest vs. Principal Enhancement**

From a regulatory point of view, there may be some difference in the treatment of interest and principal enhancements. As far as principal enhancement is concerned, the BOE has indicated that (in existing debt reduction operations) in the early years the net present value of such enhancements typically will be small in relation to the face value of the debt and, therefore, such enhancements should be disregarded for the purpose of calculating provisions and capital requirements. However, as the value of the collateral appreciates, banks will be allowed to write back amounts each year in line with their chosen accounting treatment. Hence, over time, the value of the collateral will be recognized for the purpose of enhancing the value of principal.

As far as interest enhancement is concerned UK bank auditors have taken a different approach. In cases where the interest cover is only for "limited" number of months and is in principle exhaustible after only a short period of the total life of the bonds, it is not taken into account when assessing appropriate provisioning levels. Presumably when the interest cover
becomes large "enough" the present value of the cover would be taken into account in determining
reserve and capital requirements. The BOE has not drawn a very clear line for banks between
those cases where enhancements should be considered in establishing reserves and those where
enhancements should be ignored.
### United Kingdom

#### Matrix of Regulatory, Tax and Accounting Treatment of Different Financial Instruments

<table>
<thead>
<tr>
<th>Instrument</th>
<th>Accounting Treatment</th>
<th>Tax Treatment</th>
<th>Regulatory Tax Treatment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reduced Rate Loan</td>
<td>Loans recorded at face value less permanent diminutions in value.</td>
<td>Reduced interest earnings lead to lower taxable income.</td>
<td>Same as accounting treatment.</td>
</tr>
<tr>
<td></td>
<td>Exact treatment uncertain.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Exit Bond (Par Exchange)</td>
<td>Same as above. Loss to be recognized depends on management's assessment of net realizable value.</td>
<td>Same as Reduced Interest Loan.</td>
<td>Same as accounting treatment.</td>
</tr>
<tr>
<td>Exit Bond (Discounted)</td>
<td>Transactions recorded at either the net book value of the loan or the market value of the security received.</td>
<td>Tax loss may be recognized equal to difference between face value of the security received and face value of original loan. No further write down will be permitted unless it reflects the ultimate irrecoverability of the face value of the security received.</td>
<td>Same as accounting treatment.</td>
</tr>
<tr>
<td>Debt/Equity Conversion</td>
<td>Must be accounted for fair value. Carrying value of the debt surrendered would often be taken as estimate of fair value, but it should be reviewed regularly. If fair value of equity less than carrying value of loan, the rest of loan portfolio is not contaminated.</td>
<td>Fair value used to determine tax liability.</td>
<td>Converted loan substracted from country exposure for purposes of mandatory reserving.</td>
</tr>
<tr>
<td>Buyback</td>
<td>Loss must be charged against reserves and excess loss charged to profit and loss account.</td>
<td>Tax loss depending on difference between accounting loss and provision. There may be a write back of provisions if the value of cash received is greater than the carrying value of the loan sold.</td>
<td>Loss recognized equal to different provision levels before and after.</td>
</tr>
<tr>
<td>Section</td>
<td>Description</td>
<td>Incremental.</td>
<td>Same as accounting treatment.</td>
</tr>
<tr>
<td>-------------------------------</td>
<td>-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------</td>
<td>------------------------------------------------------------------------------</td>
<td>-------------------------------</td>
</tr>
<tr>
<td>New Money</td>
<td>Accounted for at face value with provisions at same level as existing exposure to achieve required provisioning.</td>
<td>LLRs are tax deductible as discussed in text for LLRs on existing loans.</td>
<td></td>
</tr>
<tr>
<td>Interest Capitalization</td>
<td>No definitive treatment. While interest arrears remain outstanding banks are expected to maintain a 100% provision against the amount of arrears. However, if arrears are subsequently capitalized or otherwise refinanced as part of a debt restructuring agreement, the normal matrix-indicated level of provisions would apply. Where future interest income is capitalized, matrix-indicated provisions would probably apply.</td>
<td>Capitalized interest might be taxed to the extent that it is recognized as income. Inland Revenue matrix should be applied. If not recognized as income, taxed as received. Payments received cannot be applied to principal as in the U.S.</td>
<td></td>
</tr>
<tr>
<td>Conversion into Local Currency Loan at Current Exchange</td>
<td>Fair value accounting provisions will depend on exchange rate variations.</td>
<td>Write down is allowable if it reflects ultimate irrecoverability of loan.</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Current exchange rate used to calculate net realizable value.</td>
<td></td>
</tr>
</tbody>
</table>
UK

ANNEX 1: BANK OF ENGLAND LETTER TO AUTHORIZED FINANCIAL INSTITUTIONS

The Revised Bank of England Matrix

To UK Incorporated Authorized Institutions with Exposures to Countries Experiencing Debt Servicing and Repayment Difficulties

Country Debt Provisioning

In August 1987 the Bank wrote to all UK incorporated institutions authorized under the Banking Act which had exposures to countries experiencing debt repayment and servicing difficulties to encourage them to reconsider the adequacy of their provisions against exposures to such countries. Accompanying that letter was a framework for objective analysis developed by the Bank for measuring the extent of the difficulties of each country (the matrix); this framework has been used during the last two years as a basis for discussions between the Bank and each institution so that an appropriate level of country debt provisions for supervisory purposes can be determined.

In the light of two years' experience the Bank has now reviewed the structure of the matrix and the factors contributing to the assessment of repayment difficulties. The Bank has also looked again at the level of provisions indicated by the matrix, bearing in mind the widespread market perception that the situation among debtor countries has on balance deteriorated. The result of this review is reflected in a number of technical changes in the matrix and in a significant increase in the average level of provisions produced by its application.

A copy of the revised matrix is attached; the Bank proposes that it should be used in the same manner as the existing framework as a basis for discussion between the Bank and each institution.

I draw your attention to two changes in particular. The first concerns the source of the minimum score required to trigger provisions. In the 1987 matrix a minimum score of 10 from category A and B factors (evidencing actual default) was required before the question of provisioning arose; provisioning could not be triggered by category C (economic) factors alone. The Bank now believes it right that indicators which provide evidence about the likelihood of debt repayment difficulties in the future, even without actual default, should be capable of triggering provisioning; therefore, while the minimum score of 10 remains, it now applies regardless of the source.

Second, in order to avoid sudden changes in future provisioning requirements the Bank believes that a smoothing technique should be introduced based on a moving average. The technique is described in paragraph 8 of the attached paper; this will be introduced from the date of this letter, not retrospectively.

The Bank considers that, for supervisory purposes, it is desirable to set out a framework within which an appropriate level of provision against sovereign and other country risk exposures can be assessed. The matrix which is attached to this paper has been revised to allow such a view to be formed on a country by country basis.
The Matrix

There are three stages in the process of deciding an appropriate level of provision:

(i) to identify countries with current or potential repayment difficulties;

(ii) to identify the nature of those difficulties and the extent of the country’s problems; and

(iii) to determine, at this point, what proportion of exposures to that country is unlikely to be repaid in full.

A number of factors or criteria can be identified to help make this decision. These factors can be incorporated in a matrix and weighted to reflect their relative significance for determining the appropriate level of provision in respect of an exposure. They fall into three categories, namely:

A Factors which evidence a borrower's inability or unwillingness to meet its obligations, whether at the due date or thereafter;

B Factors which show a borrower's current difficulties in meeting its obligations; and

C Factors which provide evidence of the likelihood of repayment difficulties either persisting or arising in the future.

The matrix includes a total of 16 factors under these three categories. They can be applied to any country and to any type of exposure taken either in aggregate or by type of exposure. The aim has been to identify a range of observable factors which point to the likelihood of a partial or total failure to repay. For this reason differing levels of maximum score are attributed to the different factors, reflecting their perceived relative weight in the aggregate assessment of repayment difficulties.

The factors and the weights attaching to them are set out in the matrix which is attached to this paper, together with a note of the definitions to be used in completing it. Only one factor (16) is to be weighted within a range according to individual judgment.

It is suggested that a minimum score of 10 is required before the appropriateness of provisioning needs to be considered.

Method of Scoring

The total score for a country in simply the sum of the individual scores for each factor. Changes in the circumstances of individual countries should be taken account of by updating country scores whenever provisioning levels are redetermined.

In order to avoid excessive volatility in the scores, the Bank considers it appropriate to take a moving average over fifteen months, starting from the date of this paper, as the basis for determining the level of provisions.
Setting the Level of Provisions

Once the moving average has been determined, levels of provision should be established within the following broad bands:

<table>
<thead>
<tr>
<th>Score</th>
<th>Provision</th>
</tr>
</thead>
<tbody>
<tr>
<td>10-24</td>
<td>5-13%</td>
</tr>
<tr>
<td>25-39</td>
<td>14-23%</td>
</tr>
<tr>
<td>40-54</td>
<td>24-37%</td>
</tr>
<tr>
<td>55-69</td>
<td>38-58%</td>
</tr>
<tr>
<td>70-84</td>
<td>59-75%</td>
</tr>
<tr>
<td>85-99</td>
<td>76-89%</td>
</tr>
<tr>
<td>100-119</td>
<td>90-96%</td>
</tr>
<tr>
<td>120-145</td>
<td>97-100%</td>
</tr>
</tbody>
</table>

Scope of Application

There are two alternatives:

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

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

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

Banking Supervision Division, Bank of England
January, 1990

Notes on Column Definitions

'A' Factors

(1) Moratorium in effect

Column to score unilateral action by a country to limit its debt servicing payments to a creditor, either totally or partially. Score 2 if a moratorium has been in effect for up to three months; score 4 for a moratorium in effect for over three and up to twelve months; score 8 for a moratorium in effect for over twelve and up to 36 months. Any moratorium in effect for over 36 months scores 12.

(2) Rescheduled at any time in the last 5 years, or in the process of rescheduling, or has significant transfer problems and/or a limit on debt servicing without agreement from creditors.

Column to score a country that has rescheduled either commercial or official debt in the last five years. Score 6 for a rescheduling agreement signed
more than three and up to five years ago; score 8 for an agreement signed more than two and up to three years ago. Score 12 for:

(i) an agreement signed up to two years ago:

(ii) an agreement in principle to reschedule; and

(iii) a country which, exceptionally, in the last five years has refused to cooperate in the rescheduling process and whose debt stance is such, or whose transfer problems are so severe, that under normal circumstances it would have had to reschedule in the last five years and in all probability would still have arrears.

(3) Second or more rescheduling of principal amounts rescheduled since January 1983, or transfer problems recorded in column 2.

Column to score a country that has rescheduled principal already rescheduled since January 1983. Score 6 for a re-rescheduling agreement signed more than two and up to five years ago; score 8 for an agreement signed more than twelve months and up to two years ago. Score 12 for:

(i) an agreement signed up to twelve months ago;

(ii) an agreement in principle to re-reschedule; and

(iii) a country which, exceptionally, in the last five years has refused to cooperate in the rescheduling process and whose debt stance is such, or whose transfer problems are so severe, that it would have had to reschedule at least twice in the last five years and in all probability would still have arrears.

'B' Factors

(4) Significant arrears of interest or principal to IFI's.

Column to score a country that is in arrears on either interest or principal to the International Financial Institutions (IMF, World Bank, Regional Development Banks) over the threshold to be declared ineligible to draw on the General Resources Account (in the case of the IMF) or to stop disbursement of loans (in the case of the World Bank and Regional Development Banks). Score 10 where arrears have existed for less than two years; score 15 where they have existed for more than two years.

(5) Arrears of principal or rescheduled loans from other external creditors excluding agreed arrears

Column to score any current arrears of principal on loans (either original or rescheduled) from external creditors other than those taken into account in column (4). Exclude arrears effectively capitalized with the agreement of creditors during the course of the negotiation of a refinancing package. Score 4 for arrears in existence for up to three months; score 8 for arrears in existence for over three months and up to twelve months; score 10 for arrears in existence for over twelve months.
(6) Arrears of interest on original or rescheduled loans from other external creditors excluding agreed arrears

Column to score any current arrears of interest on loans (either original or rescheduled) from other external creditors. Exclude arrears effectively capitalized with the agreement of creditors during the course of the negotiation of a refinancing package. Score 4 for arrears in existence for up to three months; score 8 for arrears in existence for over three months and up to twelve months; score 10 for arrears in existence for over twelve months.

(7) New money to clear arrears, or capitalization of interest arrears, or Paris Club rescheduling of arrears

Column to score an increase in a country's external indebtedness (in comparison with the level as it would have been had repayments of principal been made as they fell due) resulting from agreements (including those of the Paris Club) which effectively capitalize arrears (excluding agreed arrears) of interest or which reschedule arrears on principal. This applies inter alia to capitalization of arrears on previously rescheduled principal and of long-standing arrears on unrescheduled principal but excludes payment delays on principal not previously rescheduled which arise during the preparatory stages of a rescheduling agreement. Score 4 for such an agreement signed more than three and up to five years ago; score 8 for an agreement signed more than two and up to three years ago; score 10 for an agreement signed in the last two years.

'C' Factors

(8) Interest service ratio

This is defined as interest payable (including interest due but not paid) divided by the value of exports of goods and services (including interest receipts and other factor services) in the latest available twelve months and rounded to one decimal place. An interest service ratio of between 15.0% and 24.9% scores 3; a ratio of between 25.0% and 34.9% scores 5; a ratio of between 35.0% and 44.9% scores 7; a ratio of 45.0% or more scores 10.

(9) Visible import cover

This is defined as the number of months' import cover (i.e. the annual value of imports divided by 12 and then divided into reserves for the latest available period, the result rounded to one tenth of a month). Reserves should include gold valued at 75% of the market price for the relevant period. Import cover of between 2.0 and 3.9 months scores 3; cover between 1.0 and 1.9 months scores 5; cover of between 0.5 and 0.9 of a month scores 7; cover of 0.4 of a month or less scores 10.

(10) Debt/GDP ratio
This is defined as total external debt divided by Gross Domestic Product for the latest available period expressed as a percentage and the result rounded to the nearest one tenth of a percentage point. A ratio of between 50.0% and 74.9% scores 3; a ratio of between 75.0% and 99.9% scores 5; a ratio of between 100.0% and 149.9% scores 7; a ratio of 150.0% and over scores 10.

(11) Debt/exports ratio

This is defined as the total external debt divided by the value of exports of goods and services (including interest receipts and other factor services) for the latest available 12 months expressed as a percentage, the result rounded to the nearest percentage point. A debt export ratio of between 200% and 299% scores 3; a ratio of between 300% and 399% scores 5; a ratio of between 400% and 599% scores 7; a ratio of 600% or more scores 10.

(12) Not meeting IMF targets/unwilling to go to IMF

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

(13) Unfilled financing gap over next 12 months excluding agreed arrears during restructuring negotiations

Column to score a country which has an unfilled external financing gap between its prospective payments outflows and its prospective inflows over the next 12 months after taking into account all currently available sources of finance. Do not score in cases where an agreement in principle with main creditors to fill a financing gap has been concluded, even where the gap has not actually been filled and arrears remain.

(14) Market price

Column to score according to the secondary market "bid" price for the country’s debt (as a percentage of face value): for a price of between 50.00% and 69.99% score 2; for a price of between 30.00% and 49.99% score 4; for a price of between 10.00% and 29.99% score 8; for a price of less than 10.00% score 12.

(15) High dependence on single source of income, commodity export, single commodity based export, service earning

Score 2 if 30.0% or more of the value of a country’s exports of goods and services in the latest available 12 months comprised of a single primary commodity, commodity based product or source of service earnings (e.g. workers' remittances).

(16) Other factors

Score any number from 0 to 5 depending on your assessment of other conditions in the country (whether economic or political) which affect its ability to repay indebtedness both now and in the future.
Finance Act 1990

73. (1) In Schedule 4 to the Finance Act 1988 (business expansion scheme: private rented housing), in paragraph 13 (exclusion of expensive dwelling-houses):

(a) in sub-paragraph (2) (assumptions to be made in arriving at value at the relevant date), for paragraph (a) there shall be substituted:

"(a) on the assumption that the dwelling-house was in the same state as at the valuation date,"; and

(b) sub-paragraph (3) (which includes the assumption that the locality was in the same state as at the valuation date) shall be omitted.

(2) This section shall apply where the valuation date is on or after 20th March, 1990.

74. After section 88 of the Taxes Act 1988 there shall be inserted:

88A. (1) For any period of account of a company ending on or after 20th March 1990, section 88B shall have effect for the purpose of restricting the extent to which a debt to which subsection (2) below applies may be estimated to be bad for the purposes of section 74(j); and:

(a) any deduction which may fall to be made in computing the company's profits or gains for the period, and

(b) any addition which may fall to be so made (for example because the relevant percentage of the debt for the period is smaller than the amount estimated to be bad for an earlier period), shall be determined accordingly.

(2) Subject to subsection (3) below, this subsection applies to any debt:

(a) which is owed by an overseas State authority, or

(b) payment of which is guaranteed by an overseas State authority, or

(c) which is estimated to be bad for the purposes of section 74(j) wholly or mainly because due payment is or may be prevented, restricted or subjected to conditions.

(i) by virtue of any law of a State or other territory outside the United Kingdom or any act of an overseas State authority, or
(ii) under any agreement entered into in consequence or anticipation of such a law or act.

(3) Subsection (2) above does not apply to interest on a debt or to a debt which represents the consideration for the provision of goods or services.

(4) In this section “overseas State authority means”--

(a) a State or other territory outside the United Kingdom,

(b) the government of such a State or territory,

(c) the central bank or other monetary authority of such a State or territory,

(d) a public or local authority in such a State or territory, or

(e) a body controlled by such a State, territory, government, bank or authority;

and for this purpose “controlled” shall be construed in accordance with Section 840.

88B. (1) Where this section has effect in relation to a debt, no more than the relevant percentage of the debt shall be estimated to be bad for the purposes of section 74(j).

(2) The relevant percentage of a debt for any period of account of the company is such percentage (which may be zero) as may be determined in accordance with regulations by reference to the position at the end of that period.

(3) Subsection (2) above has effect subject to the following provisions of this section, and in those provisions:

(a) “the base period” means the last period of account of the company ending before 20th March 1990, and

(b) “the base percentage”, in relation to a debt, means such percentage (which may be zero) as may be determined in accordance with regulations by reference to the position at the end of the base period.

(4) If for any period of account of the company which ends less than two years after the base period the percentage provided for in subsection (2) above in relation to a debt is greater than the base percentage, the base percentage shall be the relevant percentage for the first-mentioned period.

(5) If for any later period of account of the company the percentage provided for in subsection (2) above in relation to a debt is greater than the base percentage increased by five percentage points for each complete year (except the first) that has elapsed between:
(a) the end of the base period, and
(b) the end of the later period in question.

then the base percentage as so increased shall be the relevant percentage for the later period.

(6) In relation to a company which had no periods of account ending before 20th March 1990, the relevant percentage in relation to a debt shall be the same as it would have been on the assumption that the company had had such periods of account (and that any notional periods of account before its first actual period of account had been of one year each).

(7) In this section "regulations" means regulations made by the Treasury; but the Treasury shall not make any regulations under this section unless a draft of them has been laid before and approved by a resolution of the House of Commons.

88C. (1) Where:

(a) on or after 20th March 1990 a company incurs in respect of debt a loss which would be allowed as a deduction in computing the amount of the company's profits or gains under Case I or Case II of Schedule D,

(b) section 88A (2) applies to the debt,

(c) either:

(i) a deduction is made in respect of the debt in accordance with section 74(j) for any period of account of the company before that in which the loss in incurred, or

(ii) the debt was acquired by the company on or after 20th March 1990 for a consideration greater than the price which it might reasonably have been expected to fetch on a sale in the open market at the time of acquisition, and

(d) the amount of the loss is greater than 5 percent of the debt,

then, subject to subsection (3) below, only such part of the loss as equals 5 percent of the debt shall be allowed as a deduction for the period of account in which the loss is incurred; but further parts calculated in accordance with subsection (2) below may be allowed for subsequent periods until the loss is exhausted.

(2) The part of the loss allowed as a deduction for any period of account after that in which the loss is incurred shall not exceed such amount as, together with any parts allowed under this section for earlier
periods, is equal to 5 percent of the debt for each complete year that has elapsed between:

(a) the beginning of the period in which the loss was incurred, and

(b) the end of the period in question.

(3) Subsections (1) and (2) above shall not apply to a loss incurred on a disposal of the debt to an overseas State authority if the State or territory by reference to which it is an overseas State authority is the same as that by reference to which section 88A (2) applies to the debt.

(4) References subsections (1) and (2) above to the incurring of a loss include references to the making of a deduction, otherwise than in accordance with section 74(g), in respect of a reduction in the value of a debt; and for the purposes of those subsections such a deduction shall be treated as made immediately before the end of the period of account for which it is made.”

75. In section 79(11) of the Taxes Act 1988 (contributions to local enterprise agencies made before 1st April 1992 to be deductible as expenses), for “1992” there shall be substituted “1995”.

76. After section 79 of the Taxes Act 1988 there shall be inserted:

79A. (1) Notwithstanding anything in section 74, but subject to the provisions of this section, where a person carrying on a trade, profession or vocation makes any contribution (whether in cash or in kind) to a training and enterprise council or a local enterprise company, any expenditure incurred by him in making the contribution may be deducted as an expense in computing the profits or gains of the trade, profession or vocation for the purposes of tax if it would not otherwise be so deductible.

(2) Where any such contribution is made by an investment company any expenditure allowable as a deduction under subsection (1) above shall for the purposes of section 75 be treated as expenses of management.

(3) Subsection (1) above does not apply in relation to a contribution made by any person if either he or any person connected with him receives or is entitled to receive a benefit of any kind whatsoever for or in connection with the making of that contribution, whether from the council or company concerned or from any other person.

(4) In any case where:

(a) relief has been given under subsection (1) above in respect of a contribution, and
(b) any benefit received in any chargeable period by the
contributor or any person connected with him is in any way
attributable to that contribution,

the contributor shall in respect of that chargeable period be charged
to tax under Case I or Case II of Schedule D, or if he is not
chargeable to tax under either of those Cases for that period under
Case VI of Schedule D, on an amount equal to the value of that
benefit.
UK

ANNEX 2: Letter from Inland Revenue to the British Bankers' Association

January 1, 1983

Letter from Inland Revenue to the British Bankers' Association outlining recommended tax treatment of provisions against sovereign loans.

Country-Risk Debts

The following statement of the Board of Inland Revenue's practice in relation to the tax treatment of country-risk debts is contained in a letter sent to the British Bankers' Association on 17 January 1983:

The Board confirms that, in their view, the following general principles are applicable in determining the extent to which specific provisions for country-risk debts—as for debts generally—can properly be allowed for tax purposes.

a. It is for each individual bank to decide on the amount of any specific provisions which it regards as appropriate and to justify such provisions for tax purposes.

b. Whether a specific provision can properly be allowed for any debt can be determined only in accordance with the relevant tax law and in the light of the particular circumstances of that debt, including, as regards a sovereign debt, the present and prospective ability of the debtor country to service its debts. (By a “sovereign debt” is meant a debt incurred by a government agency or guaranteed by a government or government agency.)

c. Subject to all other circumstances the re-scheduling of a debt, or of the interest thereon, does not of itself necessarily preclude the allowance of a specific provision in respect of that debt.

d. Where interest is overdue on a debt and the bank is taxable on an accruals basis, a provision may be allowable against that interest until such time as it is paid.

e. Any specific provision allowed for tax is subject to annual review, even if, during the year, there has been no recover of the debt. This review will have regard, amongst other things, to any changes in the economy of the debtor country which might have a bearing on the prospects of recovering the debt.

f. In the case of an overseas commercial debt, account is taken of any overseas government intervention (e.g. exchange control) which may prevent or render doubtful payment of interest or repayment of the debt.

The Board is, of course, concerned that the Inspectors of Taxes should apply tax principles in a consistent way. They recognize that the treatment of country-risk debts may involve special or unusual factors, and they are ready, therefore, to consider any particular difficulties which may occur."
16 October 1990

DRAFT REGULATIONS FOR CALCULATING DOUBTFUL SOVEREIGN DEBT ELIGIBLE FOR TAX DEDUCTIONS

Draft regulations were laid yesterday before the House of Commons setting out the rules to be used in arriving at the maximum tax deduction available for doubtful sovereign debt.

The draft regulations take into account comments received from interested parties on the draft published for consultation on 15 August 1990. They will be made by the Treasury once approved by a resolution of the House of Commons.

Copies of the draft regulations may be obtained by writing to the Board of Inland Revenue, Sovereign Debt Consultation, Room 9, New Wing, Somerset House, Strand, London WC2R 1LB.

NOTES FOR EDITORS


2. Sections 88A, 88B and 88C, Income and Corporation Taxes Act 1988 contain the changes to the system of tax relief for doubtful sovereign and certain related debts announced by the Chancellor in his Budget speech. Under the new system the maximum amount of debt eligible for deduction as a trading expense will be calculated by a formula method. This method, which is contained in the draft regulations, follows broadly the existing Bank of England guidelines (commonly known as the Bank of England "matrix"). It sets objective criteria which will give an indication of the risk that a debt is unlikely to be repaid. Scores are prescribed for each criterion and a table converts the points score into the maximum percentage of debt allowable for tax.

3. Further information on the changes to the tax treatment of doubtful sovereign debt was included in the Inland Revenue Press Release of 20 March 1990 "New scheme of tax relief for doubtful sovereign debt".
The Debts of Overseas Governments (Determination of Relevant Percentage) Regulations 1990

Made................................. 1990

Coming into force..................... 1990

The Treasury, in exercise of the powers conferred on them by section 88B of the Income and Corporation Taxes Act 1988(a), hereby make the following Regulations, a draft of which has been laid before, and approved by a resolution of, the House of Commons:

Citation and commencement

1. These Regulations may be cited as the Debts of Overseas Governments (Determination of Relevant Percentage) Regulations 1990 and shall come into force on 1990.

Interpretation

2. (1) In these Regulations, unless the context otherwise requires -

"the A, B and C factors" mean the factors so described in Schedule 1 to these Regulations;

"debt" means a debt to which section 88A(2) of the Income and Corporation Taxes Act 1988(b) applies;

(a) 1988 c.1; section 88B was inserted by section 74 of the Finance Act 1990 (c.29).
(b) Section 88A was inserted by section 74 of the Finance Act 1990.
"overseas State authority" has the same meaning as in section 88A(4) of the Income and Corporation Taxes Act 1988;


(2) For the purposes of these Regulations a debt is connected with a State or territory —

(a) in the case of a debt which is owed by, or payment of which is guaranteed by an overseas State authority, when it is the State or territory by reference to which the overseas State authority is an overseas State authority; and

(b) in the case of a debt due payment of which is or may be prevented, restricted or subject to conditions —

(i) by virtue of any law of a State or other territory outside the United Kingdom or any act of an overseas State authority, or

(ii) under any agreement entered into in consequence or anticipation of such a law or act,

when it is the State or territory whose law it is or by reference to which the overseas State authority is an overseas State authority.

Determination of relevant percentage

3. (1) This regulation provides for the determination of the percentage of a debt by reference to the position at the end of a period of account of a company for the purposes of subsections (2) and (3) of the principal section.

(2) Subject to paragraph (4), the percentage referred to in paragraph (1) shall be that given by Schedule 2 to these Regulations as corresponding to the number which is found by —

(a) aggregating the numerical values (as adjusted where necessary in accordance with paragraph (5)) attributed by Schedule 1 to these Regulations to such of the A, B and C factors as are applicable at the end of the period of account in question in the case of the State or territory with which the debt is connected,

(b) aggregating the values (as so adjusted) attributed to such of those factors as are so applicable at the end of each of the four consecutive periods of three months which end with the period ending three months before the end of the period of account in question, and
(c) calculating the figure which results from dividing the aggregate of the values at the end of each of the periods referred to in sub-paragraphs (a) and (b) by the number of those periods and, if that figure is not a whole number, rounding it up to the next whole number.

(3) Paragraph (4) applies where-

(a) at the end of a period of account of a company, or

(b) at the end of one of the four consecutive periods of three months which end with the period of three months before the end of a period of account of a company,

(in paragraph (4) referred to as "the attributed value date") it is found that a numerical value of ten or more is attributed for the first time by Schedule 1 to these Regulations in the case of the State or territory with which the debt is connected.

(4) Where this paragraph applies-

(a) for the purposes of the aggregation required by paragraph (2)(b) only those values shall be taken into account which are attributed to factors which are applicable in the case of the State or territory in question at the end of the consecutive periods of three months ending on or after the first attributed value date, and

(b) for the purposes of the calculation required by paragraph (2)(c) only those periods shall be taken into account which end on or after the first attributed value date.

(5) Where the aggregated numerical values attributed by Schedule 1 to these Regulations to such of the A, B and C factors as are applicable at the end of a period are less than 15, those values shall be adjusted by attributing to the C factors one half of the numerical values attributed by that Schedule in place of the values actually so attributed.

Transitional provisions

4. (1) In relation to the last period of account of a company ending before 20th March 1990, in regulation 3(2) sub-paragraphs (b) and (c) shall be omitted.

(2) In relation to periods of account of the company -

(a) ending on or after 20th March 1990 and before 20th June 1990, in regulation 3(2)(b) the words "each of the
four consecutive periods of three months which end with" shall be omitted;

(b) ending on or after 20th June 1990 and before 20th September 1990, in regulation 3(2)(b) for the word "four" there shall be substituted the word "two";

(c) ending on or after 20th September 1990 and before 20th December 1990, in regulation 3(2)(b) for the word "four" there shall be substituted the word "three".

(3) Where, in relation to a period of account of the company, regulation 3(2) applies as modified by paragraph (1) or (2), regulation 3(4) shall have effect as if the references in that paragraph to paragraph (2)(b) and (c) were to those sub-paragraphs as so modified.

1990 Two of the Lords Commissioners of Her Majesty's Treasury
SCHEDULE 1

Regulations 2(1) and 3(2)

A, B AND C FACTORS

INTRODUCTORY

1. (1) In this Schedule -

"arrears" in relation to repayment of debt, or the payment of interest on debt, do not include arrears arising out of temporary administrative delay which are expected to be corrected within a reasonable period of time and "in arrear" shall be construed accordingly;

"external creditor" in relation to a debt, means a creditor which is an international financial institution, an overseas State authority (other than one which is an overseas State authority by reference to the State or territory with which the debt is connected) and any other creditor who is resident outside the State or territory by reference to which section 88A(2) of the Income and Corporation Taxes Act 1988 applies to the debt;

"international financial institution" means the International Monetary Fund, the World Bank, the International Bank for Reconstruction and Development, the International Development Agency, the International Finance Corporation and any regional development bank;

"regional development bank" means any of the European Investment Bank, the African Development Bank, the Asian Development Bank, the Caribbean Development Bank, the Inter-American Development Bank, and any other investment or development bank constituted by international agreement which is for the time being specified in Schedule 2 to the Banking Act 1987(a).

(2) References in this Schedule -

(a) to the relevant date are references to the end of any period of account or period of three months at which the applicability of the A, B and C factors is in question for the purposes of determining a percentage under these Regulations;

(b) to an agreement to reschedule or restructure obligations do not include an agreement by a State or territory to make repayment of debt and payment of outstanding interest in full at an earlier date than the due date or to make future such repayments or payments by reference to earlier dates than the due dates;

(a) 1987 c.22.
(c) to the figures for the latest available period and at the latest available date are respectively to the figures for the latest period of twelve months ending before the relevant date for which figures are available and to the figures at the latest date before the relevant date for which figures are available.

THE A FACTORS

2. The A factors in the case of a State or territory, which are factors which show the inability or unwillingness of the State or territory to meet its obligations when they are due or thereafter, and the numerical values attributable to them are those given by Table A below.

Table A

<table>
<thead>
<tr>
<th>Factor</th>
<th>Numerical value</th>
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<tbody>
<tr>
<td>(1) The State or territory has taken unilateral action to suspend,</td>
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<td>in whole or in part, repayment of debts or payment of interest on</td>
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<td>debts to a general class of external creditors and at the relevant</td>
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<td>date the suspension has been in effect -</td>
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<td>for three months or less, or is about to end;</td>
<td>2</td>
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<tr>
<td>for more than three months but not more than one year;</td>
<td>4</td>
</tr>
<tr>
<td>for more than one year but not more than three years;</td>
<td>8</td>
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<tr>
<td>for more than three years.</td>
<td>12</td>
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</tbody>
</table>

(2) (a) The State or territory has entered into an agreement to reschedule or restructure its obligations as to repayment of debts, or payment of interest on debts, to external creditors and at the relevant date the agreement was entered into -

more than three years ago but not more than five years ago; 6

more than two years ago but not more than three years ago; 8
two years ago or less or has only been reached in principle.

(b) The State or territory within the period of five years preceding the relevant date has refused to co-operate in a rescheduling or restructuring of its obligations as to repayment of debts, or payment of interest on debts, to external creditors and either -

(i) has imposed a limit on its performance of such obligations without the agreement of those creditors, or

(ii) has had severe problems in performing those obligations so that it might have been expected to have entered into an agreement on more than one occasion to reschedule or restructure them and, if it had done so, would be likely still to have arrears of repayment or interest at the relevant date.

(3) (a) The State or territory has entered into a further agreement to reschedule or restructure obligations as to repayment of debt to external creditors which have already been rescheduled or restructured since January 1983 and at the relevant date the further agreement was entered into -

more than two years ago but not more than five years ago;

more than one year ago but not more than two years ago;

one year ago or less or has only been reached in principle.

(b) The State or territory within the period of five years preceding the relevant date has refused to co-operate in a rescheduling or restructuring of its obligations as to repayment of debt to external creditors and either -
(i) has imposed a limit on the performance of such obligations without the agreement of those creditors, or

(ii) has had severe problems in performing those obligations,

so that it might have been expected to have entered into an agreement on more than one occasion to reschedule or restructure them and, if it had done so, would be likely still to have arrears of repayment at the relevant date.

THE B FACTORS

3. The B factors in the case of a State or territory, which are factors which show that the State or territory has current difficulties in meeting its obligations, and the numerical values attributable to them are those given by Table B below.

Table B

<table>
<thead>
<tr>
<th>Factor</th>
<th>Numerical value</th>
</tr>
</thead>
<tbody>
<tr>
<td>(4) The State or territory is in arrear in repaying debt, or in paying interest on debt, to one or more international financial institutions so that, in the case of the International Monetary Fund, it has been declared ineligible to draw on the general resources of that Fund as held in the General Resources Account or any account which may be substituted for it by amendment of the Articles of Agreement of that Fund or, in the case of the World Bank, the International Bank for Reconstruction and Development, the International Development Agency, the International Finance Corporation or a regional development bank, disbursement of loans to it has stopped and at the relevant date the arrears in question have existed</td>
<td></td>
</tr>
</tbody>
</table>
for less than two years; 10
for two years or more. 15

(5) The State or territory is in arrear in repaying debt to external creditors other than international financial institutions, the arrears have neither been the subject of a rescheduling or restructuring agreement nor been repaid and immediately lent back to that State or territory and at the relevant date they have existed -
for three months or less; 4
for more than three months but not more than one year; 8
for more than one year. 10

(6) The State or territory is in arrear in paying interest on debt to external creditors other than international financial institutions, the arrears have neither been the subject of a rescheduling or restructuring agreement nor been paid and immediately lent back to that State or territory and at the relevant date they have existed -
for three months or less; 4
for more than three months but not more than one year; 8
for more than one year. 10

(7) The State or territory has entered into an agreement to reschedule or restructure its obligations as to repayment of debts, or payment of interest on debts, to external creditors generally, or with creditors which are governments of other States or territories in particular, under which -
(a) the creditors have lent further amounts to enable the State or territory to make repayments of debt which are in arrear and pay arrears of interest; or
(b) arrears of interest have been added to the amount of outstanding debt or have been paid and immediately lent back to the State or territory; or

(c) arrears in repayment of debts which have already been the subject of a rescheduling or restructuring agreement or of unrescheduled debts are rescheduled or restructured;

and at the relevant date the agreement was entered into -

more than three years ago but not more than five years ago; 4

more than two years ago but not more than three years ago; 8

two years ago or less. 10

THE C FACTORS

4. The C factors in the case of a State or territory, which are factors which provide evidence of the likelihood of that State or territory having persistent or future repayment difficulties, and the numerical values attributable to them are those given by Table C below.

Table C

<table>
<thead>
<tr>
<th>Factor</th>
<th>Numerical Value</th>
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<tbody>
<tr>
<td>(8)</td>
<td>The interest service ratio applicable in the case of the State or territory on the basis of the figures for the latest available period, that is to say the result of dividing the total amount of interest payable for that period by the value of exports of goods and services (including interest and net transfer receipts) for the same period, expressing that result as a percentage and rounding that percentage to the nearest one tenth of one per cent., is -</td>
</tr>
</tbody>
</table>

-71-
between 15 per cent. and 24.9 per cent.; 3
between 25 per cent. and 34.9 per cent.; 5
between 35 per cent. and 44.9 per cent.; 7
45 per cent. or more. 10

(9) The number of months for which the State or territory has visible import cover at the relevant date, that is to say the result rounded to the nearest one tenth of one month of the formula

\[ \frac{A \times 12}{B} \]

where -

A is the amount or value of the assets held by the monetary authorities of the State or territory, which may freely be used to support the exchange value of the currency of that State or territory, on the basis of the figures at the latest available date including assets which may readily be used to obtain such assets and gold valued at 75 per cent. of its price expressed in United States dollars per fine troy ounce as declared at the morning fixing in the London Bullion Market on that date; and

B is the annual value of imports of goods and services into the State or territory on the basis of the figure for the latest available period;

is -

between 2 and 3.9 months; 3
between one month and 1.9 months; 5
between 0.5 and 0.9 of one month; 7
0.4 of one month or less. 10

(10) The ratio between debt and gross
domestic product applicable in the case of the State or territory on the basis of the figures for the latest available period, that is to say the total external debt of the State or territory at the end of that period divided by the annual total of goods produced and services provided in that period, the result being expressed as a percentage and rounded to the nearest one tenth of one percentage point, is -

between 50 and 74.9 per cent.; 3
between 75 and 99.9 per cent.; 5
between 100 and 149.9 per cent.; 7
150 per cent. or greater. 10

(11) The ratio between debt and exports applicable in the case of the State or territory on the basis of the figures for the latest available period, that is to say the total external debt of the State or territory at the end of that period divided by the value of exports of goods and services (including interest and net transfer receipts) in that period, the result being expressed as a percentage and rounded to the nearest percentage point, is -

between 200 per cent. and 299 per cent.; 3
between 300 per cent. and 399 per cent.; 5
between 400 per cent. and 599 per cent.; 7
600 per cent. or greater. 10

(12) The State or territory at the relevant date -

(a) is in breach of performance criteria which were set for it (and which have not been subsequently waived) in an agreement which it has entered into with the International Monetary Fund; or
(b) has problems in relation to its external debt of such a nature as would justify an approach to the International Monetary Fund for assistance, but it is —

(i) unwilling to do so, or

(ii) unable to do so because it is not a member of that Fund.

(13) The State or territory is expected to have in the period of twelve months following the relevant date an external financing gap, that is to say the surplus on the prospective balance of its external transactions on both current and capital account (other than those associated with the servicing of external debt) is unlikely to be sufficient to meet in full its obligations to repay debt or to pay interest on debt for that period in the absence of exceptional financing measures, such as agreement with its creditors to postpone the carrying out of its obligations, or for the provision of new loans to secure repayment of existing loans, and agreement by its creditors to reduce their claims to repayment or to interest, and accumulation of arrears, and no agreement has been reached in principle with its principal creditors to fill that gap.

(14) The price expressed as a percentage of its face value which the external debt of the State or territory might reasonably have been expected to fetch on a sale in the open market at the relevant date, is —

between 50 per cent. and 69.99 per cent.; 2

between 30 per cent. and 49.99 per cent.; 4

between 10 per cent. and 29.99 per cent.; 8

smaller than 10 per cent. 12
(15) 30 per cent. or more of the value of the exports by the State or territory of goods and services on the basis of the figures for the latest available period is represented by exports of a single primary commodity or commodity based product or by receipts from a single category of service earnings.

SCHEDULE 2

CORRESPONDING PERCENTAGES

A percentage shown in column 2 of the Table below shall correspond to the number shown opposite to it in column 1.

<table>
<thead>
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<th>Column 1</th>
<th>Column 2</th>
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<td>Number</td>
<td>Percentage</td>
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<td>78</td>
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<td>79</td>
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<td>80</td>
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</tbody>
</table>
EXPLANATORY NOTE

(This note is not part of the Regulations)

These Regulations provide the method of determining the "relevant percentage" in relation to a debt owed to a company which is owed or guaranteed by an overseas State authority (or payment of which is or may be prevented or restricted by an overseas State). By virtue of section 88B(1) of the Income and Corporation Taxes Act 1988 the "relevant percentage" of such a debt is the maximum amount of that debt which may be estimated to be bad for the purposes of section 74(j) of that Act.

Regulation 1 provides for citation and commencement.

Regulation 2 contains definitions.

Regulation 3(1) and (2) provides that the relevant percentage of a debt is to be determined by

- finding the numerical values attributed to various factors by Schedule 1 (which relate to the overseas State and its ability to repay, or make payments of interest on, its debts) which are applicable at the end of the period of account of the company;

- aggregating those numerical values with the values attributed by Schedule 1 to factors applicable at the end of each of the four periods of three months which end with the period ending three months before the end of the period of account;

- averaging the result; and

- finding the percentage shown in Schedule 2 as corresponding to that average.

Regulation 3(3) and (4) modifies the process of aggregation and averaging when a numerical value of ten or more is attributed for the first time to factors relating to a particular State. Regulation 3(5) reduces the numerical values attributed at the end of a period to certain of those factors by half when the aggregate of all the numerical values attributed at that date is less than 15.

Regulation 4 contains transitional provisions excluding aggregation and averaging in relation to periods of account of a company ending before 20th March 1990 and modifying the process of aggregation and averaging in relation to periods ending before 20th December 1990.
Canada

Under the Bank Act, the Office of the Superintendent of Financial Institutions (OSFI) is responsible for regulating and supervising banks in Canada. The OSFI is responsible to the Minister of Finance. Tax policy and regulations are formulated by the Department of Finance.

Since 1984 provisioning requirements on LDC loans have been established by Canadian banking authorities. Guidelines have been issued intermittently over the last seven years. In October 1990 OSFI issued a revised and more comprehensive guidelines on provisioning for country risk and accounting for debt reduction operations. These guidelines are contained in the annexes to this section. The highlights of these guidelines are:

1. Banks must maintain a minimum level of provisions of 35% on their exposures to designated countries. There is no maximum limit.\(^\text{16}\)

2. The number of designated countries is now 43. Jordan was added to the list in 1990;

3. Debt or equity acquired in auctions, purchases, and swaps through arm’s length transactions is recorded at the time of the transaction at fair value. Because of this write down to fair value the exposure is excluded from the provisioning basket; and

4. Debt acquired in a restructuring is recorded at face value. Because the transaction is not a voluntary market transaction there is no assurance that face value reflects fair value. As a result the debt is included in the basket; however, in determining the provisioning level, any write down and the current value of any collateral are taken into account.

Institutional Framework

In Canada, banks may only be chartered under federal jurisdiction. The Bank Act, which is required to be renewed every ten years serves as the basis for federal chartering of banks and defines the powers, requirements and restrictions applicable to them. One of the key elements of the New Directions policy of December 1986 was the decision to bring together into one organization the Department of Insurance and the Office of the Inspector General of Banks, an appointment under the Minister of Finance. The Inspector Office, responsible for regulating Canada’s chartered banks since 1925, received broader powers under the July 1987 Act which established the Office of the Superintendent of Financial Institutions (OSFI). The OSFI is responsible for regulating and supervising banks, insurance, trust loan and investment companies, and co-operative credit associations that are chartered, licensed or registered by the federal government. In addition, the OFSI is responsible for supervising federally regulated pension funds.

The OSFI is required to perform an examination of each bank at least once a year. The OSFI conducts a credit analysis and reviews the internal audit procedures of each bank. The OSFI also reviews the work of a bank’s external auditors. The Bank Act prohibits public access to examination data. The OSFI also prescribes accounting principles to be followed by banks. These principles normally follow accounting principles generally accepted in Canada; however, there may be some differences.

\(^{16}\) This is unchanged from the 1989 guideline.
Tax policy is implemented through the Income Tax Act and the Income Tax Regulations issued by the Department of Finance. Tax law is enforced by Revenue Canada Taxation. Major changes in the taxation of banks resulted from the 1987 tax reform.

**Disclosure Guidelines**

Banks are required to publish annual and quarterly worldwide consolidated financial statements. The accounts of companies which are more than 50 percent owned are fully consolidated with those of the parent bank. Comprehensive regulatory reports are submitted to the bank supervisor each quarter. These reports include financial statements and geographic exposure data on a country by country basis. Loans to a single country in excess of one percent of bank risk assets must be published in the bank's annual report. Canadian banks have formal limits on the size of individual loans. However, these guidelines do not apply to sovereign or public sector borrowers. As part of the annual audit, the joint auditors are required to report to the OSFI loans to any borrower with obligations which exceed one half of one percent of the total of the paid-in capita, contributed surplus and retained earnings of the bank, in respect of which, in their opinion, loss to the bank is likely to occur or increase from an amount previously reported. The provisions for doubtful credits are prudential in nature and cannot be determined on an item-by-item basis, and are not tax deductible.

**Non-Performing Loans**

The OSFI has set forth the accounting and reporting standards for non-performing loans in its Manual of Reporting Forms and Instructions for Chartered Banks. The OSFI distinguishes between two categories of non-performing claims: nonaccrual and renegotiated reduced rate loans.

Non-accrual loans are loans on which interest is not being accrued due to the existence of reasonable doubt as to the ultimate collectibility of principal or interest. The criteria governing the nonaccrual definition are where:

1. There is doubt as to the ultimate collectibility of principal of interest. Any private sector claim with a specific provision signifying doubt as to the ultimate collectibility of principal or interest is thereby an automatic candidate for non-accrual status. However, loans with general provisions are not automatically classified as non-accrual. Where interest on such a loan is contractually past due 90 days and management concludes there is reasonable doubt as to ultimate collectibility of principal of interest they become automatically reclassified as non-accrual.

2. Interest is contractually past due 90 days. Management has the option to exercise an override in this respect, for instance where the loan is fully secured and management expects the interest arrearage will be eliminated in the normal course of business. However, when interest becomes past due 180 days on such loans, they are automatically classified nonaccrual. Only in extenuating circumstances can this rule be set aside, for instance where the problem credit is fully secured and in the process of collection.

Renegotiated reduced rate loans, have to meet well defined standards to avoid nonaccrual status. Generally, the loans are automatically to revert to nonaccrual status, where interest on the revised terms becomes past due 90 days. The remain in nonaccrual status until they meet the conditions for returning to performing status, are written off or repaid.
In fiscal quarter when any claim becomes nonaccrual, all related accrued interest recorded to date is reversed against interest income for the quarter.

The treatment of subsequent payments applicable to nonaccrual claims, draws an important distinction between private sector and sovereign risk income recognition. In the case of private sector claims, subsequent cash collections are to be applied to expunge partial write-offs and/or specific provisions pertaining to the claim; only when the principal amount of the claim has been fully reinstated can further cash payments be credited to current income as received. In contrast, subsequent to a sovereign risk claim being classified as nonaccrual, all cash interest payments received may be recognized as income.

Accounting and Regulatory Issues

Country Risk Provisioning

Since 1984, under supervisory requirements, banks have been establishing provisions of a prudential nature against their exposures to countries that have restructured or experienced difficulties in servicing all or part of their external debt to commercial banks.

In October 1990, OSFI issued Guideline No. EDC 1990-10 (see Annex 2), which describes the appropriate regulatory treatment of provisions, debt restructurings and debt reduction operations. The regulations are fairly comprehensive and helpfully compiled in one location by OSFI. They are summarized below and contained in full in the annex to this section.

The minimum level of provisions against exposures to 44 designated countries has been set by the Superintendent at 35 percent. Prior to October 1989 a 45% ceiling on sovereign risk provisioning was maintained. This 45% ceiling limit was removed in October 1989. This change was made because several banks, on the basis of their assessments of their own portfolios, decided to set aside the maximum 45% of country risk provisions and to establish additional general provisions against these same exposures. Therefore in order to retain all provisions against this class of risk under one heading OSFI decided to remove the maximum limit of 45%.

The criteria for determining the minimum level of country risk provisions are as follows:

\[
100\% \times \frac{(TP + L - PSS)}{(PA - PSS)} = \text{Provision level where,}
\]

- \(TP\) = total provisions
- \(L\) = losses recorded on debt acquired in a restructuring
- \(PSS\) = private sector specifics
- \(PA\) = provisionable assets

"Provisionable assets" refers to the total exposure adjusted upward by any write-down on loans exchanged for the debt acquired in a restructuring that are carried on the books of the bank at the reporting date. Total exposure represents total claims on the basis of the ultimate risk less local claims funded by local deposits where such local claims and deposits are denominated in local currency. The amount to be included in total exposure for debt acquired in a restructuring is the face value of the acquired debt reduced by the current value of any collateral of the principal.
Included in the base are all remaining public and private sector loan, deposit and security assets of the consolidated bank for which the ultimate risk resides in the designated countries. except for:

- United Mexican States Collateralized Floating Rate Bonds Due 2008
- equity acquired in a debt equity exchange; and
- debt acquired from a third party as a result of an arm's-length transaction (other than a restructuring).

The treatment for these instruments is also outlined in the October 1990 regulations.

Total provisions established according to these guideline include outstanding specific and general country risk provisions charged to Loan Loss Experience, the Special Provision for Losses on Transborder Claims, and the Provision for Credit Losses, and any related hedging gains or losses. The allocation of provisions against each country is left to the discretion of the individual banks, based on their assessments of the situation.

Canadian banks have reserves well in excess of the 35% minimum as illustrated by the Table 1 below.

<table>
<thead>
<tr>
<th>Bank</th>
<th>Reserve Levels as of October 31, 1990</th>
</tr>
</thead>
<tbody>
<tr>
<td>Royal Bank of Canada</td>
<td>72%</td>
</tr>
<tr>
<td>Canadian Imperial Bank of Commerce</td>
<td>100%</td>
</tr>
<tr>
<td>Bank of Montreal</td>
<td>63%</td>
</tr>
<tr>
<td>Bank of Nova Scotia</td>
<td>67%</td>
</tr>
<tr>
<td>Toronto Dominion</td>
<td>n/a/1</td>
</tr>
<tr>
<td>National</td>
<td>62%</td>
</tr>
</tbody>
</table>

1. Toronto Dominion currently has no exposure to any of the 43 countries on the OSIE list.

Source: Department of Finance, Canada

The list of 43 countries against which reserves are required was revised in July 31, 1990 when a 3rd country was added to the list. The Superintendent of Financial Institutions may, at his discretion, add countries to the list if a country:

1. has negotiated or is negotiating an agreement to reschedule or restructure principal and/or interest on its sovereign risk obligations to foreign commercial banks; or

2. has declared or requested a moratorium on payment of principal and/or interest on its foreign commercial bank debt extending beyond 180 days for interest or one year for principal, with a view to restructuring the debt; or

3. has fallen more than 180 days in arrear of interest and/or one year of principal on its obligations to foreign commercial banks.
At the discretion of the Superintendent, a country may be removed from the list if it:

(1) has withdrawn its request for, or declaration of, a formal moratorium of principal and/or interest on foreign commercial bank debt, and payments of principal and interest have been brought up to date in accordance with the original terms of the debt; or

(2) has not requested further rescheduling and has met its payments of principal and interest on rescheduled foreign commercial bank debt without additional rescheduling or involuntary bank financing for a period of:

(a) five years from concluding an agreement to reschedule or restructure foreign commercial bank debt or an agreement to provide additional involuntary bank financing; or

(b) two years from signing a formal rescheduling agreement of foreign commercial bank debt or agreement to provide additional involuntary bank financing if, by the end of this period, the country has demonstrated its ability to raise funds with a maturity exceeding one year on international capital markets on a voluntary, unsecured basis in its own name or that of a government-controlled organization or agency. Such ability should be demonstrated by at least two transactions of substance, with participation on a broadly subscribed basis.

The Canadian system has the advantage of being relatively simple. The basket concept recognizes that within the basket there is a range in the quality of exposures. Banks are given the flexibility to apply provisions accordingly as long as on an overall basis they meet the 35% mandatory minimum. The fact that most Canadian banks have voluntarily increased their provisions well beyond the 35% level (see table 1) suggests that the provisioning levels may now be driven more by the market place and than the prudential concerns of the regulator.

**Mexican Financing Package**

The Office of the Superintendent of Financial Institutions (OSFI) issued accounting instructions for the principal-reduction and interest-reduction options in Mexico's refinancing package. These are reproduced in the annexes below and are analyzed in the section “Tax and Regulatory Treatment of Specific Instruments.”

**Tax Issues**

The tax treatment of sovereign loans follows initially from the accounting treatment established by OSFI. There are, however, some important differences that restrict the amounts that are deductible for tax purposes. The accounting treatment necessarily must take into account the prudential concerns of the regulator. Also, several of the Canadian banks have booked high levels of reserves for doubtful debts on sovereign loans to ensure that these loans can no longer have an adverse impact on their earnings. These factors often lead to accounting reserves that are in excess of the actual loss in value of the sovereign loans, which is the basis of the Canadian tax treatment.

A key question in determining the tax consequences of a transaction in Canada is determining whether or not the asset received by a bank is included in the basket of exposures that are subject to mandatory provisioning. If a sovereign loan is in the basket, then the tax deduction
for a doubtful debt provision established on the loan is generally limited to 45% of the principal value of the loan. It should be pointed out that banks may only recognize the 45% tax deduction on such loans to the extent that they actually establish provisions for regulatory and accounting purposes. It would not be possible, for example, for a bank to establish the minimum regulatory provision of 35% of the face value of the original loan, but claim a tax deduction of 45%.

If a transaction occurs that removes an asset from the basket, then a bank may realize tax deductions in excess of the 45% deduction. Generally, market-based sales of sovereign loans in the basket to third parties that operate at arm's length from the bank would qualify for such treatment. In such cases, the tax consequences are calculated by comparing the loss on disposition of the loan to any deductions previously claimed on the loan. Suppose, for example, that a bank sold a loan in the basket with a face value of 100 for cash of 30. Assume also that the bank had already claimed the maximum tax provision of 45 on the loan. Then the deduction of the loss of (100-30) = 70 on the loan and an inclusion of the prior year's reserve of 45 in taxable income would result in a net additional tax deduction of 25.

Examples of transactions that would remove a sovereign loan from the basket would include buybacks or conversions of debt to equity. The Aztec bonds received in exchange for Mexican loans were removed from the basket because the transaction was the result of market-based auction. In order to derive the tax consequences for the Aztecs, a fair market value approach was used to compute the proceeds of disposition. In the more recent Mexican financing package, the terms and conditions of the bonds exchanged by the bank were negotiated, and no auction was used. This was not considered to be an arm's length market process; consequently, the bonds received by the banks remained in the basket and the transaction was neutral in its tax consequences for banks.

On March 7, 1990 the Minister of Finance released draft regulations applicable to financial institutions (see Annex 1). Included were several technical changes to the tax treatment of sovereign loans. In particular, with respect to debt exchanges where both the original and the acquired loan are subject to mandatory provisioning by the Office of the Superintendent of financial Institutions (that is, both are in the basket), the tax treatment of doubtful debt reserves is computed based on the principal of the original loan. This would apply to loans involved in the recent Mexican financing package where for example, a discount bond with a principal amount of $65 was received in exchange for a bond with a principal amount of $100. Suppose the fair value of the bond received was $40. The maximum tax deduction resulting from this transaction would be $45. This consists of a $60 loss for tax purposes on the disposition of the original loan, and a taxable reserve inclusion of $15 on the new instrument computed as:

\[
(45\% \times \text{face value of original loan}) - \text{loss} = 45 - 60 = -15
\]

(A negative reserve on the exchange was also 45, there are no tax consequences to the exchange. Without the technical amendment, the method of computation under the previous draft regulations did not always provide this neutral result.)

Later this year, further draft amendments concerning sovereign loans were communicated to the Canadian banks. These changes are consequential to the new guidelines issued by OSFI in October 1990. In particular, the revised regulatory guidelines remove swaps of sovereign loans from the basket. The draft tax amendments ensure that swaps or a series of transactions in sovereign loans that do not reduce the consolidated bank's portfolio of sovereign loans will not result in tax deductions that are in excess of 45%. One example would be a swap of loans between a Canadian bank and a foreign bank in which the Canadian parent sells a Brazilian loan and its off-shore subsidiary acquires another Brazilian loan as part of the exchange. Such
sovereign loan transactions are not viewed as market-based sales to third parties that operate at arm's length from Canadian banks.

**Tax and Regulatory Treatment of Specific Instruments**

**Discount Bonds**

Banks are required to record the bonds at face value. The difference between the face value of the bond and the original value of the loan is charged to provisions.

The discount bonds are included in the basket of exposures for country risk provisioning purposes at face value less the current value of any OECD-government securities pledged as collateral. The required provision calculated on this exposure would be reduced by the write-down recorded.

For example, if a $100 loan provisioned at 50% was exchanged for a $70 bond (i.e. $30 loss) and the value of the collateral was $2, Mexican exposure would be $70 - $2 = $68. Assuming the bank does not increase its provisions, the level of country risk provisions would be:

\[
\frac{20 + 30}{68 + 30} = 51\% 
\]

Note that for purposes of calculating the provision level, the amount of loss incurred in the exchange is added back to the remaining reserves as well as to the amount of exposure. A bank must maintain a provision of at least 35% of its country exposure. If, as a result of the transaction, the bank's reserve level against country exposure is reduced to less than 35%, the bank must add to its provisions. However, if its provision level is in excess of 35% (as in the example above), no reduction in country risk provisions may be recorded.

The current treatment of discount bonds differs from the guidance issued in the February 17, 1988 letter to commercial banks describing the appropriate treatment for Mexico bonds maturing in 2008 (so-called “Aztec” bonds). The Aztec bonds were excluded from the basket for country risk provisioning purposes, whereas the bonds issued as part of the 1990 package are included. OSFI's rationale for this treatment was that the Aztec bond transaction was a voluntary transaction done at fair market value while the more recent transaction was a non-discretionary refinancing.

In the case of the Aztec bonds, banks were required to fair value the bonds received. The letter stated that the carrying value of the bonds held for investment should not exceed the original face value of the debt swapped less the level of country risk provisions previously established.

The tax treatment of the discount bonds will depend on whether or not the bonds that are received in the exchange are included in the basket. Since the Aztec bonds were excluded from the basket, the Canadian banks were able to obtain tax deductions in excess of 45% to the extent that the fair value of the acquired bonds was less than the 55% tax basis of the original Mexican loans. In the case of the bonds that were part of the recent Mexican financing package, there were no tax consequences since the acquired bonds were included in the basket. It should be noted in calculating the maximum 45% tax provision available on these bonds, one uses the principal value of the original loans and no adjustment is made for the value of the collateral received.
Par Bonds

For regulatory and accounting purposes the bonds would be placed on bank books at face value. No new provisions would be required, unless the overall provisioning required against the basket of countries was increased. Although the current value of collateral would be taken into account in calculating country exposure, banks are not allowed to reduce provisions upon accepting the instrument. Banks would be required to maintain a minimum level of provisions of 35% with respect to their exposure. As the collateral on the par bonds grows in value, banks would be allowed to reverse provisions over the life of the asset.

Since the Par Bonds are included in the basket there would be no tax consequences to accepting the par bond. The tax treatment essentially follows the accounting treatment, except that for tax purposes the value of the collateral would be ignored.

Buyback

For tax, accounting and regulatory purposes banks are required to charge to provisions the difference between the value of the cash received and the face value of the original loan. Only if the discount on the buyback is greater than the amount of outstanding reserves would banks be required to make an additional charge to income. For tax purposes the sale of the loan for cash removes the asset from the basket and, hence, the difference between the tax basis in the original loan and the value of the cash received can be deducted from income.

New Money

New money loans and bonds are treated as existing loans. A mandatory minimum provision of 35% is required for regulatory purposes, but banks may establish higher provisions if they wish. The provision is tax deductible up to the 45% level.

OSFI has not issued guidance on the treatment of any credit enhancement with respect to a new money loan. Possibly the treatment could be consistent with the principles applied in the context of Mexico's recent bond issue to reduce the country exposure against which provisions must be established by the current value of any credit enhancement that accompanied the new money loan.

Obviously, the large capital cost to making a new money loan is a disincentive to participating in new money packages. 17

For tax purposes the value of credit enhancement on a new money loan would be ignored if the same procedure was followed as in the recent Mexican bond issue.

Interest Capitalization

Neither OSFI nor the Minister of Finance has addressed the question of interest capitalization in the sovereign context. For example, the Minister of Finance has not yet indicated how the agreement contained in the Costa Rican package with respect to past due interest should be treated. As described above, banks in the Costa Rican package accepted new 15 year notes as "payment" on the interest arrears. With respect to the accounting treatment, there seem to be three basic choices:

17 Note that banks are not required to maintain provisions on each loan; they are required to maintain a minimum level of 35% provisions against a basket of exposures. Right now, Canadian banks have a lot of flexibility, if desired, in providing provision-free loans.
i) recognize no income for accounting purposes.

ii) recognize income for accounting purposes equal to the market value of the notes received or, alternatively, to the market value of the enhancement on the notes.

iii) recognize income for accounting purposes equal to the face value of the notes received.

Given the frequently stated reluctance of the Canadian supervisory authorities to allow interest capitalization, it seems likely that no income would be recognized for accounting purposes if past due interest was capitalized in the context of a debt restructuring package i.e. capitalized interest would be 100% provisioned. For tax purposes, no income for tax is recognized if banks are no longer accruing unpaid interest. However, if the interest is capitalized, banks would be allowed to maintain a provision of only 45% against the capitalized interest. Banks would be required to recognize as taxable income that portion of the capitalized interest (i.e. 55%) which is not offset by provisions. Due to these potentially adverse tax consequences, Canadian banks may find participation in an agreement to capitalize interest unattractive.

Canadian banks and fiscal authorities may need to clarify their position on the treatment of interest capitalization in the context of the debt restructuring packages for Brazil and Argentina, both of which are likely to involve the settlement of substantial amounts of past due interest.

**Interest vs. Principal Enhancement**

The current value of any OECD-government securities pledged as collateral on the principal is taken into account in calculating exposure to designated countries. OSFI does not take into account the current value of interest credit enhancement in calculating the value of Mexican exposure. For capital adequacy purposes claims collateralized by cash or by securities for bills issued by OECD central governments, OECD central banks or multilateral development banks, may be assigned the risk weight of collateral. This applies only to collateral on the principal value. No other forms of collateral may reduce risk weighting. If the current value of the collateral covers less than the book value of the asset, only that part of the asset that is fully covered may receive the appropriate lower weight.

For tax purposes, principal and interest enhancements are ignored in the sense that banks (where the loan is still in the basket) are allowed a maximum tax deductible provision of 45% of the original face value of the loan regardless of the credit enhancement attached to new instruments. If an enhancement occurs such that OSFI decides to remove the new instrument from the basket and which the tax authorities view as an arm's length market-based transaction to a third party, then this enhancement would affect the fair value of the proceeds of disposition in determining the net tax deduction.
Canada

Matrix of Regulatory and Tax Treatment of Different Financial Investments

<table>
<thead>
<tr>
<th>Instrument</th>
<th>Accounting Treatment</th>
<th>Tax Treatment</th>
<th>Regulatory Treatment&lt;sup&gt;a/&lt;/sup&gt;</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reduced Rate Loan</td>
<td>No loss recognized assuming exchange at par. The asset remains in the basket for country risk provisioning purposes.</td>
<td>No net tax impact since the asset remains in the basket.</td>
<td>See accounting treatment. Disclosure may be required.</td>
</tr>
<tr>
<td>Par Bond</td>
<td>Same as above.</td>
<td>No net tax impact since the asset remains in the basket.</td>
<td>See accounting treatment.</td>
</tr>
<tr>
<td>Discount Bond</td>
<td>No loss recognized as long as discount is not greater than provisions. The asset remains in the basket, as described in guidelines.</td>
<td>No net tax impact since the asset remains in the basket.</td>
<td>See accounting treatment.</td>
</tr>
<tr>
<td>Debt/Equity Conversion</td>
<td>Must be accounted for at fair value. Excluded from basket for country risk provisioning purposes.</td>
<td>Asset is fair valued for tax purposes and loss allowed equal to difference between old tax basis and the fair value of the equity.</td>
<td>Currently, equities are included in country exposure; rules are under review.</td>
</tr>
<tr>
<td>(arm's length market transaction)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Buyback</td>
<td>Loss must be recognized equal to difference between existing book value and value of cash received. Loss charged to CRPs; if provisions are insufficient, loss results.</td>
<td>Loss allowable equal to difference between old tax basis and value of cash received.</td>
<td>Loss recognized equal to difference between old regulatory value and value of cash received.</td>
</tr>
<tr>
<td>Interest Capitalization</td>
<td>No income may be recognized on capital interest. Interest not capitalized continues to be recognized when income received.</td>
<td>Capitalized interest might be treated as taxable income, with maximum tax provision of 45%.</td>
<td>Same as book treatment OCC EC No. 229.</td>
</tr>
<tr>
<td>Conversion into Local</td>
<td>Fair value accounting.</td>
<td>Fair value used to determine if a change in tax basis has taken place.</td>
<td>Fair value accounting; excluded from country exposure for purposes of calculating mandatory CRP if denominated and funded in local currency.</td>
</tr>
<tr>
<td>Currency Loan at Current Exchange</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<sup>a/</sup> Note that all country risk provisions are excluded from regulatory capital.
PART LXXX

PRESCRIBED RESERVE AMOUNT AND RECOVERY RATE

8000. For the purposes of clause 20(1)(1)(ii)(A) of the Act, the prescribed reserve amount for a taxpayer for a taxation year means the aggregate of:

(a) where the taxpayer is a bank an amount equal to the lesser of

(i) the amount of the reserve reported in its annual report for the year to and accepted by the relevant authority or, where the taxpayer was throughout the year subject to the supervision of the relevant authority but was not required to file an annual report for the year with the relevant authority, in its financial statements for the year, as general provisions or as specific provisions, in respect of loans or lending assets of the taxpayer made or acquired by it in the ordinary course of its business, and

(ii) an amount in respect of the loans or lending assets of the taxpayer that were reported for the year by the taxpayer to the relevant authority, in accordance with the guidelines established by the relevant authority, as part of the taxpayer’s total exposure to designated countries for the purposes of determining the taxpayer’s general provisions or specific provisions referred to in subparagraph (i) (in this subparagraph referred to as the “loans”) equal to the amount determined by the formula

\[ 45\% \times (A+B) - (B+C) \]

where

A. is the aggregate of all amounts each of which is the amount that would be the amortized cost of a loan to the taxpayer at the end of the year if the definition “amortized cost” in section 248 of the Act were read without reference to paragraphs (e) and (i) thereof,

B. is the aggregate of all amounts of which is the amount, if any, by which the principal amount of a loan outstanding at the time it was acquired by the taxpayer exceed the amortized cost of the loan to the taxpayer immediately after the time it was acquired by the taxpayer, and

C. is the aggregate of all amounts each of which is
a. an amount in deducted in respect of a loan under clause 20(1)(1)(ii)(B) of the Act in computing the taxpayer's income of the year, or

b. an amount in respect of a loan determined as the amount, if any, by which

i. the aggregate of all amounts in respect of the loan deducted under paragraph 20(1)(p) of the Act in computing the taxpayer's income for the year or a preceding taxation year exceeds

ii. the aggregate of all amounts in respect of the loan included under paragraph 12(1)(i) of the Act in computing the taxpayer's income for the year or a preceding taxation year, and

(b) an amount, not exceeding a reasonable amount, of a reserve for the year in respect of doubtful loans or lending assets of the taxpayer (other than a loan or lending asset described in subparagraph (a)(ii)) computed by

(i) identifying loans or lending assets of the taxpayer with respect to which a reserve could be claimed under clause 20(1)(1)(ii)(B) of the Act,

(ii) segregating particular types of loans or lending assets of the taxpayer referred to in subparagraph (i) into different classes based on the length of time that interest or principal payable to the taxpayer in respect thereof has been in arrears, and

(iii) determining the aggregate of all amounts each of which is the amount determined by multiplying the amortized cost to the taxpayer at the end of the year of loans or lending assets of a class described in subparagraph (ii) by the historical loss experience of the taxpayer in respect of that class.

For the purposes of clause 20(1)(1)(ii)(B) and subparagraph 20(1)(1.1)(ii) of the Act, the prescribed recovery rate is 10%.

For the purposes of paragraph 8000 (a),

(a) the principal amount outstanding at any time of a lending asset of a taxpayer that is a share of the capital stock of a corporation is the part of the consideration received by the corporation for the issue of the share that is outstanding at that time, and

(b) where a taxpayer,

(i) realized a loss on the disposition of a loan or lending asset that was an exposure to a designated country (in this paragraph referred to as the "former loan") for consideration that included another loan or lending asset that was an exposure to that designated country (in this paragraph referred to as the "new loan"), and

8001. For the purposes of paragraph 8000 (a),

8002. For the purposes of paragraph 8000 (a),
(ii) included the loss referred to in subparagraph (i) in the calculation of its provisionable assets as reported in its annual report for the year to the relevant authority, in accordance with the guidelines established by the relevant authority, for the purposes of determining the taxpayer's general provisions or specific provisions in respect of exposures to designated countries.

the principal amount outstanding of the new loan at the time it was acquired by the taxpayer shall be deemed to be equal to the principal amount outstanding of the former loan immediately before that time.

8003. Where a taxpayer elects to have this section apply by notifying the Minister in writing within 90 days from the date this section is published in the Canada Gazette, the loans or lending assets of the taxpayer that are described in subparagraph 8000 (a)(ii) shall not include any loan or lending asset acquired by the taxpayer before November 1988, from a person with whom the taxpayer was dealing at arm's length.

October 11, 1990 Draft Amendments

DRAFT

8000. ....................

(a) ....................

(i) ....................

(ii) an amount in respect of the loans or lending assets of the taxpayer at the end of the year that were made or acquired by the taxpayer in the ordinary course of its business and reported for the year by the taxpayer to the relevant authority, in accordance with the guidelines established by the relevant authority, as part of the taxpayer's total exposure to designated countries for the purposes of determining the taxpayer's general provisions or specific provisions referred to in subparagraph (i) or that were acquired by the taxpayer after August 16, 1990 and reported for the year by the taxpayer to the relevant authority, in accordance with the guidelines established by the relevant authority, as an exposure to a designated country (in this subparagraph referred to as the "loans") equal to the positive or negative amount, as the case may be, determined by the formula

................................

................................

(b) .....................
8004. For the purposes of subparagraph 8000 (a)(ii), where a loan or lending asset of a person (in this section referred to as the "holder") related to a taxpayer

(a) was reported for the year by the taxpayer to the relevant authority, in accordance with the guidelines established by the relevant authority, as an exposure to a designated country,

(b) was acquired by the holder or another person related to the taxpayer after August 16, 1990 as part of a series of transactions or events in which the taxpayer or a person related to the taxpayer disposed of a loan or lending asset that

(i) for the taxation year immediately preceding the particular year in which it was disposed of, was a loan or lending asset that was reported by the taxpayer to the relevant authority, in accordance with the guidelines established by the relevant authority as an exposure to a designated country, and

(ii) was a loan or lending asset a loss arising on the disposition of which would be a loss in respect of which a deduction is permitted under Part I of the Act to the taxpayer or a person related to the taxpayer, and

(c) had an amortized cost to the holder, immediately after the time it was acquired by the holder, that was less than 55 percent of its principal amount, the following rules apply:

(d) the loan or lending asset shall be deemed

(i) to be a loan or lending asset of the taxpayer at the end of the year,

(ii) to be a loan or lending asset of the taxpayer that was acquired by the taxpayer at the time it was acquired by the holder, and

(iii) to have an amortized cost to the taxpayer, at any time, that is equal to its amortized cost to the holder at that time, and

(e) any amount in respect of the loan or lending asset deducted under paragraph 20(1)(p) or included under paragraph 12(1)(i) of the Act in computing the holder's income for a particular year shall be deemed to have been so deducted or included, as the case may be, in computing the income of the taxpayer for the year in which the particular year ends.
Guideline

Subject: **Exposures to Designated Countries**

No: **EDC 1990-10**  Date: **October 1990**

The information and instructions in this Guideline pertain to:

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A Country Risk Provisioning

Introduction

Since 1984, under supervisory requirements, banks have been establishing provisions of a prudential nature against their exposures to countries that have restructured or experienced difficulties in servicing all or part of their external debt to commercial banks. The objectives of these requirements are to

- reaffirm the primary responsibility of bank management for assessing the value of credits;
- promote the establishment of provisions against possible losses; and
- facilitate supervisory monitoring at a minimum cost.

The minimum level of provisions against exposures to 43 designated countries has been set by the Superintendent at 35 per cent. Criteria for determining the minimum level of country risk provisions and for adding to or removing countries from the list are included in this Guideline.

Banks have had and will continue to have opportunities to restructure their portfolio of loans to designated countries by such means as debt auctions, debt purchases, debt swaps and debt refinancing. Since these transactions often result in significant losses being realized and therefore a potential distortion of the provisioning level, separate accounting instructions for these transactions have been developed and are included in this Guideline.

1. Banks are required to maintain a 35 per cent minimum level of provisions for losses against their exposure to the designated countries.

The formula for calculating the level of provisions against the designated country list is:

\[
\text{Level} = \frac{\text{Total provisions} + \text{losses recorded on debt acquired in a restructuring} - \text{private sector specifics}}{\text{Provisionable assets} - \text{private sector specifics}} \times 100\% 
\]

2. Provisionable assets reduced by specific provisions against private sector commercial risk loans is the base against which qualifying provisions are measured.

For this purpose, provisionable assets is total exposure adjusted upward by any write-down on loans exchanged for the debt acquired in a restructuring that are carried on the books of the bank at the reporting date. Total exposure represents total claims on the basis of ultimate risk less local claims funded by local deposits where such local claims and deposits are denominated in local currency. The amount to be included in total exposure for debt acquired in a restructuring is the face value of the acquired debt reduced by the current value of any collateral on the principal.

Included in the base are all remaining public and private sector loan, deposit and security assets of the consolidated bank for which the ultimate risk resides in the designated countries, except for:

- United Mexican States Collateralized Floating Rate Bonds Due 2008;
- equity acquired in a debt for equity exchange; and
- debt acquired from a third party as a result of an arm’s-length transaction (other than a restructuring).

The treatment of these assets is outlined in parts B, C, and D.
3. Total provisions in this Guideline include outstanding specific and general country risk provisions charged to Loan Loss Experience, the Special Provision for Losses on Transborder Claims, and the Provisions for Credit Losses, and any related hedging gains or losses.

4. The allocation of provisions against each country is left to the discretion of the individual banks, based on their assessments of the situation.

5. Criteria for identifying countries that have encountered problems in servicing their external debt or countries that have restructured all or part of that debt are outlined on page A-4. The list of designated countries is on page A-6.
Criteria for Amending List of Designated Countries

Because the economic positions of these countries and other countries change, the Office will revise the list of countries annually (i) to include additional countries and (ii) to remove countries where it is appropriate to do so.

1. The Superintendent of Financial Institutions, at his discretion, may add to the list of countries for which provisioning is required.

This may be done if a country:

   o has negotiated or is negotiating an agreement to reschedule or restructure principal and/or interest on its sovereign risk obligations to foreign commercial banks; or

   o has declared or requested a moratorium on payment of principal and/or interest on its foreign commercial bank debt extending beyond 180 days for interest or one year for principal, with a view to restructuring the debt; or

   o has fallen more than 180 days in arrears of interest and/or one year of principal on its obligations to foreign commercial banks.

2. The Superintendent of Financial Institutions may, at his discretion, make a deletion from the list of countries for which provisioning is required.

This may be done if a country:

   o has withdrawn its request for, or declaration of, a formal moratorium of principal and/or interest on foreign commercial bank debt, and payments of principal and interest have been brought up to date in accordance with the original terms of the debt; or

   o has not requested further rescheduling and has met its payments of principal and interest on rescheduling foreign commercial bank debt without additional rescheduling or involuntary bank financing for a period of:

       o five years from concluding an agreement to reschedule or restructure foreign commercial bank debt or an agreement to provide additional involuntary bank financing; or
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two years from signing a formal rescheduling agreement of foreign commercial bank debt or agreement to provide additional involuntary bank financing if, by the end of this period, the country has demonstrated its ability to raise funds with a maturity exceeding one year on international capital markets on a voluntary, unsecured basis in its own name or that of a government-controlled organization or agency. This ability should be demonstrated by at least two transactions of substance, with participation on a broadly subscribed basis.
List of Designated Countries

1. Argentina 22. Morocco
2. Bolivia 23. Mozambique
4. Chile 25. Niger
6. Costa Rica 27. Korea, Democratic Peoples Republic of
7. Cuba (North Korea)
8. Dominican Republic 28. Panama
9. Ecuador 29. Peru
10. Gabon 30. Philippines
11. Gambia 31. Poland
12. Guinea 32. Romania
13. Guyana 33. Senegal
14. Honduras 34. Sierra Leone
15. Ivory Coast 35. Republic of South Africa
16. Jamaica 36. Sudan
17. Jordan 37. Togo
18. Liberia 38. Trinidad and Tobago
19. Madagascar 39. Uruguay
20. Malawi 40. Venezuela
21. Mexico 41. Yugoslavia
22. Zaire
23. Zambia

Exposures to Designated Countries
EDC 1990-10 Effective: July 31, 1990
The United Mexican States (UMS)
Collateralized Floating Rate Bonds Due 2008

1. The Bonds are to be treated as Mexican risk. However, they are not to be included in the definition of total exposure for the purpose of calculating country risk provisions.

2. The debt for Bond swap is an exchange transaction that should be recorded at current fair value.

3. The adjustment to fair value to account for any difference between the bid and accepted price of Bonds and principal amount of the debt tendered should be charged against country risk provisions.

4. Banks should ensure that the remaining country risk provisions against outstanding exposures, excluding the Bonds, are adequate.

5. The valuation of the bonds will depend on whether the bank’s intent is to hold the Bonds for (a) trading or (b) as an investment for the longer term.

6. Bonds held for trading should be marked to market.

7. Bonds held for investment should be recorded at cost adjusted from time to time to recognize permanent impairment in their net realizable value.

8. The carrying value of the bonds held for investment should not exceed the original face value of the debt swapped less the level of country risk provisions previously established. Any reduction in the face value of the acquired Bonds to bring the value of the Bonds to the net carrying value of the debt swapped should be charged against country risk provisions.

9. Additional write-downs in the value of the Bonds would not be charged against the country risk provisions.

10. In determining the carrying value of the bonds held for investment, consideration should be given to any additional change to the overall level of country risk provisions in this Guideline. For this purpose, the face value of the original debt swapped adjusted for the established level of country risk provisions should be
compared to the carrying value of the Bonds less the current value of the U.S. bond collateral.

11. The adequacy of provisions against Mexican debt that is not tendered or that is tendered and not sold will continue to be assessed using the country risk provisioning section of this Guideline.

12. Based on the performance of the Bonds, their classification as performing or non-performing will be subject to the criteria identified in the non-performing loans guideline.
Designated Country Debt/Equity Exchanges

1. At the time of the transaction, the equity securities should be recorded at fair value. In the absence of an objective fair valuation, the asset should be recorded at net book value, where net book value is the face value of the original asset less the level of country risk provisions established by the bank.

2. The fair value of the equity securities would be translated into Canadian dollars at the prevailing exchange rate. Any write-down to fair value to account for the difference between this value and the principal amount of the debt swapped would be charged against the country risk provisions. There should be no income inclusion as a result of this transaction, and a reassessment may be required of the adequacy of the remaining country risk provisions.

3. The equity securities acquired should be classified in:
   a) the loan realization account if the equities are obtained in substitution of a loan and are held for realization or if the equities do not meet the definition of investments that a bank is allowed to hold under the Bank Act; or
   b) the investment or trading account if the equities meet the criteria of the Bank Act and if the bank's intent is to hold the equities for (a) the longer term as an investment or (b) trading.

4. When equity securities are held in the loan realization account, subsequent specific provisions and write-downs recorded against these securities should be included in the provision for loan losses. Equity securities held in the investment or trading account should be subject to the existing permanent impairment or mark-to-market rules.

5. Income arising from assets held in the loan realization account would be recognized in accordance with the income recognition rules relating to loan realization accounts. Income on assets held in the securities portfolio would be recognized in accordance with security accounting rules, including equity accounting or consolidation where applicable. The amount of securities income recognized should, if material, be disclosed on an ongoing basis.
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of Financial Institutions

6. The equities would be excluded from the definition of total exposure for purposes of country risk provisioning but would be included with other exposures (based on ultimate risk) for purposes of reporting country exposure.
D  Designated Country Debt Acquired in an
Arm’s-Length Transaction
(Other than a Restructuring)

1. At the time of the transaction, the debt instrument should be recorded at fair
value. In the absence of an objective fair valuation, the asset should be recorded
at net book value, where net book value is the face value of the original asset
less the level of country risk provisions established by the bank.

2. The fair value of the debt instrument would be translated into Canadian dollars at
the prevailing exchange rate. In the case of a debt/debt exchange, any write-
down to fair value to account for the difference between this value and the
principal amount of the debt swapped would be charged against the country risk
provisions. There should be no income inclusion as a result of this transaction,
and a reassessment may be required of the adequacy of the remaining country
risk provisions.

3. Balance sheet classification will depend on the nature of the instrument acquired
and the intention of the bank in holding the asset.

4. Income recognition will be in accordance with existing accounting guidelines.
Specifically, income recognition on assets held in the loan or securities account
will be based on performance and subject to the criteria identified in the non-
performing loans guideline. Assets held in the loan realization account are non-
accrual.

5. When the asset is held in the loan or loan realization account, subsequent specific
provisions and write-downs recorded against the asset should be included in the
provision for loan losses. A debt instrument held in the investment or trading
account should be subject to the existing permanent impairment or mark-to-
market rules.

6. The debt instrument would be excluded from the definition of total exposure for
the purposes of country risk provisioning, but would be included with other
exposures (based on ultimate risk) for purposes of reporting country exposure.
E  Designated Country Debt Acquired in a Restructuring

1. At the date of the transaction, the debt instrument should be recorded at face value.

2. Any write-down to account for the difference between this value and the principal amount of the original debt reduced by any cash consideration received should be charged against the country risk provisions.

3. There should be no income inclusion as a result of this transaction, and a reassessment may be required of the adequacy of the remaining country risk provisions.

4. Where the debt instruments are listed on a recognized stock exchange, they should be carried in the investment or trading account, depending on whether the bank’s intent is to hold the debt instruments for (a) the longer term as an investment or (b) trading. Otherwise the debt instruments should be carried in the loan or loan realization account.

5. Based on the performance of the debt instruments, their classification as performing or non-performing will be subject to the criteria identified in the non-performing loans guideline.

6. The face value of the acquired debt instruments reduced by the current value of any OECD-government securities pledged as collateral on the principal is to be treated as exposure to the designated country.

7. The debt instruments are to be included in the definition of total exposure for purposes of this Guideline. The amount included would be the amount treated as the exposure (as defined in 6) to the designated country adjusted upward by the amount of any write-down recorded. The required provisions calculated on this total exposure would be reduced by the write-down recorded, if any. The required provisions less the write-down should never be less than zero.

8. In calculating the level of country risk provisions, total exposure would be as outlined in 7. The total provisions would include the amount of any write-down recorded.

Exposures to Designated Countries
EDC 1990-10    Effective: February 1990
United States

Regulatory policies in the United States are defined and implemented through the complicated interaction of a large number of regulatory agencies at the State and Federal levels. The most important regulators of commercial banks are the three Federal regulatory agencies: the Federal Reserve, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation. In addition the Securities and Exchange Commission (SEC) defines important reporting and disclosure guidelines for publicly held bank holding companies. Federal tax law is contained in the Internal Revenue Code (enacted by Congress) and its accompanying regulations and related rulings and interpretations by the United States Treasury. The Financial Accounting Standards Board (FASB) and the American Institute of Certified Public Accountants (AICPA) play the major roles in establishing accounting standards. The SEC, however, has the statutory authority to establish accounting standards to be used by publicly held bank holding companies in filings with the Commission.

Institutional Framework

The United States Federal banking agencies that are responsible for evaluating the financial condition of United States commercial banks and for encouraging the conduct of their operations in a safe and prudent manner are:

(a) the Board of Governors of the Federal Reserve System (FED);
(b) the Office of the Comptroller of the Currency (OCC);
(c) the Federal Deposit Insurance Corporation (FDIC).

The FED, OCC and FDIC jointly have responsibility at the Federal level for the regulation and supervision of commercial banking in the United States. In theory, the agencies have somewhat different regulatory and supervisory jurisdictions. In practice, these jurisdictions are frequently overlapping. Commercial banks have either federal or state charters. Federally chartered banks must be members of the Federal Reserve System, are supervised by the OCC, and have deposits insured by the FDIC. State chartered banks may become members of the Federal Reserve System regulated by the Federal Reserve and the State in which they are chartered or remain non-member banks regulated by the State and the FDIC.

Each of the three Federal regulatory agencies has examiners who are responsible for the evaluation and review of bank lending practices and the determination that established reserves are sufficient to provide for probable losses in the loan portfolio. OCC examiners are responsible for all national banks with Federal charters; Federal Reserve examiners are responsible for all bankholding companies and state chartered banks that are members of the Federal Reserve System, and FDIC examiners are responsible for state-chartered banks which are not members of the Federal Reserve System. Bank regulation in the United States is made especially complex because of the large number of official regulatory and supervisory institutions.

Important advances have been made to encourage a common approach among Federal regulatory institutions with respect to the regulation of international lending. Perhaps the most significant effort of this kind was the creation of the Interagency Country Exposure Review Committee (ICERC). During 1979, the FED, FDIC and OCC established ICERC in an effort to strengthen the evaluation of United States commercial banks' transfer risks. Previously, each
agency conducted independent evaluations of banks' specific foreign borrowings. With the establishment of ICERC, the supervisors were able to coordinate their evaluation of transfer risk.

Reporting requirements for publicly held banks are established by the Securities and Exchange Commission (SEC). The specific financial and statistical disclosure required for publicly held banks is contained in Industry Guide 3 to Regulation S-K. The main organization that establishes Generally Accepted Accounting Principles (GAAP) in the United States, is the Financial Accounting Standards Board (FASB), which is a private entity established in 1973. It superseded the Accounting Principles Board, its (also private) predecessor, which operated from 1959-1973. However, it should be noted that the Securities and Exchange Commission (SEC), as empowered by the Securities and Exchange Act of 1934, has the legal power to issue accounting standards. While the SEC has this power, it recognizes (as does the AICPA) the FASB's standards as authoritative. To a large extent the SEC has effectively delegated the authority for setting accounting standards to the private sector. However, the SEC and its staff provide interpretive guidance as necessary to assist public companies in complying with their reporting obligations.

Tax policies are established in the Internal Revenue Code, the official Treasury Department regulations and interpretations of this code and relevant court cases. The tax treatment of LDC debts and sovereign debt restructurings has been partially clarified through the issuance of regulations, but some areas of uncertainties remain.

Disclosure Guidelines

United States banks are required by SEC Industry Guide 3 to disclose, among other things, the following information. (In addition, there are disclosure requirements under Sections 907(a) and (b) of the ILSA; those are not discussed in this report).

1. As of the end of each of the last three reporting periods, where cross-border outstandings to borrowers in any foreign country exceed 1% of total assets, banks must disclose the following:
   - name of each foreign country; and
   - aggregate amount of cross-border outstandings in each foreign country

2. Where current conditions in a foreign country give rise to liquidity problems which are expected to have a material impact on the timely payment of interest or principal on that country's private or public sector debt, disclosure of the nature and impact of such developments should be made. Also, an analysis of the changes in aggregate outstandings to borrowers in each such country is generally required for the most recent reported period.

3. For countries whose outstandings are between .75% and 1.00% of total assets, disclose the following:
   - names of foreign countries; and
   - aggregate amount of outstandings to all such countries combined.

In addition to the specific requirements outlined above, the SEC expects disclosure of actions taken by registrants regarding their LDC portfolios. Those disclosures should be made pursuant to the guidance in SEC Industry Guide 3. Disclosure should be made of the aggregate level of allowance relative to LDC loans and the level of those loans. Aggregate exposure amounts
or allowance percentages should be defined, including amount of charge-off included or excluded. Changes in the allowance account balance should be disclosed, including the amount of charge-offs, recoveries, additional provisions, and adjustment resulting from swaps, sales, or other changes. The fair value of assets received and the face amount of debt exchanged in swap transactions, the rationale for determining the fair value of those assets, and the accounting method for the resulting investments (considering restrictions on sales, dividends, or other repatriation) should also be disclosed. United States banks also face strict disclosure guidelines with respect to nonperforming and nonaccrual loans.

Nonaccrual Loans

The decision to stop accruing interest income on loans is based on management's evaluation as to the collectibility of the interest and principal. In practice, however, certain conventions or thresholds have been established by United States commercial banks to determine when a loan should be put on nonaccrual status. Most of the convention have been implemented in order to maintain consistency with various Federal regulatory filings.

Call Report Instructions Glossary entry on Nonaccrual of Interest defines the accounting practice to be used in call reports for nonaccrual of interest:

For uniformity in financial reporting, the OCC has adopted a policy for nonaccrual of interest on delinquent loans. Banks may not accrue interest on any loan when principal or interest are in default for 90 days or more unless the loan is well secured and in the process of collection. A debt is “well secured” if it is secured (1) by collateral in the form of liens on or pledges of real or personal property, including securities, that have a realizable value sufficient to discharge the debt (including accrued interest) in full, or (2) by the guarantee of a financially responsible party. A debt is “in the process of collection” if collection of the debt is proceeding in due course either through legal action, including judgement enforcement procedures, or, in appropriate circumstances, through collection efforts not involving legal action which are reasonably expected to result in repayment of the debt or in its restoration to a current status. These guidelines are being revised under the latest version of the Comptrollers Handbook for National Bank Examiners.

When a bank places a loan in a nonaccrual status, it must consider how to account for previously accrued but uncollected interest and subsequent payments. Generally accepted accounting principles govern that accounting. One acceptable method, if the interest is considered a loss, is to reverse all previously accrued but uncollected interest against appropriate income and balance sheet accounts. For interest accrued in the current accounting period, the entry is made directly against the interest income account. For prior accounting periods, the bank charges the reserve for possible loan losses if provisions for possible interest loss were previously made. If accrued interest provisions had no been provided, the entire charge would be expensed against current earnings. A bank is expected to have a well defined policy governing charge-offs of accrued interest receivable.

A nonaccruing loan may be restored to an accruing status when:

(i) Principal and interest is no longer due and unpaid or it otherwise becomes well secured and in the process of collection; and

(ii) Prospects for future contractual payments are no longer in doubt.

The requirements for Federal Reserve and FDIC filing parallel those for the OCC described above. The SEC also requires (Guide 3, Regulation S-X) banks to report all nonaccrual
loans, the interest income that would have been recorded if loans had been current, and a statement of bank policy for placing loans on nonaccrual status.

In July 1988, the AICPA Banking Committee issued Practice Bulletin No. 5 "Income Recognition on Loans to Financially Troubled Countries". Although this bulletin does not deal explicitly with the decision to place loans on nonaccrual, it does provide some limited guidance on when income on troubled sovereign loans may be recognized. In summary, the practice bulletin requires the following:

(i) A creditor with outstanding LDC loans should reevaluate its allowance for loan losses when significant events occur affecting those loans.

(ii) Assuming that the allowance for loan losses is adequate, when a country becomes current as to principal and interest payments and has normalized relations with the international financial community, the creditor may recognize the receipt of interest payments as income.

(iii) When a country becomes fully current as to its contractual obligations for principal and interest payments to the creditor, some period of payments performance generally is necessary in order to permit returning the loan to accrual status.

Tax and Regulatory Treatment of Loan Loss Reserves

United States banks create both general and specific (ATRRs) provisions against international loans. With the exception of specific provisions mandated by federal regulators, these provisions are currently included in regulatory capital and are not deductible from taxable income. Specific provisions mandated by the Interagency Country Exposure Review Committee (ICERC) are both deductible from taxable income and excluded from regulatory capital. The specific provisions mandated by ICERC are equivalent for tax and regulatory purposes to a charge-off of worthless debt.

Prior to 1986 banks could deduct provisions from taxable income in an amount based on loss experience over the last six years ("experience method") or equal to a set percentage of eligible loans ("percentage of eligible loan method"). The 1986 Tax Reform Act repealed the tax deductibility of reserves for all banks with assets in excess of $500 million.

As a result of the 1986 Tax Reform Act banks were required to recapture reserves into taxable income over a four year period beginning in 1987. At least 10% of the reserve balance was included in income in 1987. In 1988 2/9 of the remainder, in 1989 3/9 of the remainder and in 1990 4/9 of the remainder were to be recaptured into income. If a bank has assets equal to 75% of its equity classified as (i) non-performing, (ii) non-accrual or as (iii) "troubled debt restructurings," it is classified as a "financially troubled bank," and this schedule for recapturing reserves into income is suspended until the bank is no longer so classified. Fiscal year 1990 was the last year for which this detail was relevant.

After the Brady plan was announced some commentators speculated that a few banks might have an incentive to participate in "troubled debt restructurings" given the possibility that these banks might be classified as "financially troubled banks" for tax purposes and, thereby, to delay the recapture of substantial amounts of loan loss reserves into income as of January 1990. As mentioned above, one of the criteria for classification of a financially troubled bank concerns the amount of a bank's assets that have been restructured as "troubled debts" On the other hand, pressure to recapture reserves into taxable income may provide banks with an incentive to take losses against their reserves. As a very rough estimate, approximately $8 billion in reserves
established by the largest 10 banks in the United States remains to be recaptured into taxable income as of January 1990.

Loan loss provisions are of two types: those routinely established by bank management against specific identifiable risks and general estimated losses and those mandated by federal regulators. As mentioned above those reserves (ATRRs) mandated by federal regulators are tax deductible and excluded from regulatory capital while those reserves routinely established independently of direct regulatory mandate are normally taxable and included in regulatory capital.

With respect to the first type of loan loss provision, commercial banks create a general reserve, also known as the allowance for loan and lease losses (ALLL), which usually represents an amount established for estimated losses inherent in the loan portfolio. It is usually a percentage of the portfolio that can be expected to be lost based on past experience, economic cycle and portfolio composition. The adequacy of the general reserve is subject to review by regulators and external auditors. General provisions are established by bank management in accordance with procedures which are periodically evaluated by bank examiners for consistency and prudence.

As a practical matter, the only way the ALLL can be assessed for adequacy is relative to the loans which represent the greatest risk for loss. Accordingly, management will typically attribute portions of the ALLL to individual loans and pools of loans as part of this analytical process. However, this analytical attribution in no way restricts the availability of any portion of the ALLL to cover any subsequently confirmed portfolio losses. It should also be pointed out that the establishment of a mandated ATRR does not obviate an estimation by banks of the amount of additions to the ALLL for inherent losses on cross-border lending.

Provision levels of U.S. banks have undergone an interesting progression. United States banks have increased their provisions from an average of 25% in 1988 to an average of about 60% of their exposure to troubled debtor countries in 1990. Money center banks average reserve levels from 50% to 55% of their exposure to troubled debtor countries. Comparable reserve levels for regional banks are between 70% and 75%. The provisions levels of selected U.S. banks are shown below in Table 1 as of June 1990.

The second type of provision that banks create on international loans is a country specific provision mandated by federal regulators. Federal regulators mandate these specific provisions following recommendations made by ICERC. The country specific provisions recommended by ICERC are called Allocated Transfer Risk Reserves (ATRRs).

ICERC performs uniform risk assessment across federal regulatory and supervisory jurisdictions. ICERC meets three times a year in Washington to assess the cross-border exposure of United States banks. ICERC is composed of nine federal bank examiners who base their country risk classifications on economic, social and political factors. ICERC's country risk assessment is based on a wide range of information coming from the Federal Reserve System, the Federal Reserve Bank of New York, United States money center banks, and United States government sources. ICERC ranks countries according to their debt servicing capacity and places claims on each country with debt servicing difficulties (or with prospects for such difficulties) into the following seven loan categories:

1. **Strong**: The country does not experience social, economic, or political problems which could interrupt repayment of external debt.

2. **Moderately Strong**: The country experiences a limited number of identifiable economic, social or political problems which do not presently threaten orderly repayment of external liabilities.
3. **Weak:** The country faces many difficulties which, should they not be reversed, could threaten orderly repayment of external debt.

*Non-Classified Credits Warranting Attention*

4. **Other Transfer Risk Problems ("OTRP").** This category applies when:

(i) a country is not complying with its external debt service obligations, as evidenced by arrearages, forced restructurings, or rollovers; However, the country is taking positive actions to restore debt service through economic adjustment measures, generally as part of an IMF program.

(ii) a country is meeting its debt obligations, but non-compliance appears imminent.

(iii) a country has been classified previously, but recent debt service performance indicates classification no longer is warranted. For instance, the country is complying with the terms of IMF rescheduling programs. However, sustained resumption of orderly debt service needs to be demonstrated.

*Designations Applied to Credits Adversely Affected by Transfer Risk*

5. **Sub standard:** This category applies when: (i) a country is not complying with its external debt service obligations as evidenced by arrearages, forced restructuring or rollovers; and (ii) a country is not in the process of adopting an IMF or other suitable economic adjustment program, or it is not adequately adhering to such a program; or (iii) the country and its bank creditors have not negotiated a viable rescheduling and are unlikely to do so in the near future.

6. **Value Impaired:** This category applies when a country has protracted arrearages indicated by more than one of the following:

(i) the country has not fully paid its interest for six months

(ii) the country has not complied with IMF programs (and there is no immediate prospect for compliance);

(iii) the country has not met rescheduling terms for over one year;

(iv) the country shows no definite prospects for an orderly restoration of debt service in the near future.

7. **Loss:** This category applies when the loan is considered uncollectible and of such little value that its continuance as a bankable asset is not warranted. An example would be an outright statement by the country which repudiates obligations to banks, the IMF or other lenders.

Credits to individual countries that are placed in any of the last three categories above are deemed by the agencies to be problem or "classified" foreign loans. The credits which have been “classified” due to transfer risk problems are combined with commercial loan classifications
used by the agencies in the evaluation of a bank’s asset quality and other measures of financial soundness. ICERC requires banks to establish ATRRs against those international assets that it classifies as Value Impaired. Although ICERC has not done so, it has the authority to require banks to provision against assets in other categories to which it assigns these ATRRs so long as the assignment is consistent with what the three regulatory agencies represented in ICERC believe is necessary to take into account transfer risk on loans.

The United States supervisory agencies have indicated that the levels of ATRRs would be reviewed regularly and appropriate adjustments in mandated provision levels would be made. The reserve is calculated by multiplying the reserve percentage imposed by ICERC by the face amount of exposure classified “Value Impaired”, after adjustment for guarantees. For purposes of making the calculation, any previous write-downs are added back before the amount of the specific provision is determined. As a general rule, the reserves apply to all loans except performing trade credits and performing inter-bank lines. On a case-by-case basis, ICERC may consider other exceptions.

**Accounting and Regulatory Treatment of Debt Reduction**

With respect to the regulatory and accounting treatment of LDC debt and debt service reductions, a threshold issue is whether or not the restructuring constitutes only a “modification of terms”. If the restructuring involves more than a modification of debt terms, the bank generally must record the restructured instrument at a new basis. Generally, modification of loan terms, such as changes in interest rate, maturity, amortization schedule, or principal amount, would not result in establishment of a new basis for the restructured instrument. Also, receipt of assets in partial satisfaction of the debt and modification of terms of the remaining portion would not result in a new basis for the remaining restructured debt. However, a substitution of debtors, exchange of assets in full satisfaction of the debt or a substitution of an equity instrument for the original debt would result in recognition of a new basis. Also, if an institution determines that it does not have the intent or ability to hold the restructured instrument, it must write the original or restructured loan down to its market value and recognize losses for any further market declines until the instrument is sold or repaid.

It should, however, be noted that modification of terms, alone or with partial satisfaction through assets, can result in a writedown. The writedown is really driven by restructuring loss and collectibility loss. Modification of terms provides the means for possibly having no change in basis, but it does not drive the determination.

The SEC staff has issued two significant documents which discuss accounting for foreign debt restructurings; Staff Accounting Bulletin No. 75 (SAB 75) (see Annex 2), and the July 14, 1989 letter from the Chief Accountant of the SEC to the Under Secretary of the Treasury. Although these two documents address specific foreign restructuring transactions, the guidance in these documents has applicability to other restructurings.

SAB 75 was issued to provide guidance in connection with the Mexico/Morgan bond exchange which took place in 1988. SAB 75 required that a bank which tendered debt in an auction process must value the tendered debt at its fair market value consistent with management’s demonstrated intention to dispose off the debt rather than hold the debt to maturity. If the tendered debt was subsequently accepted, the value of the exchange was based on the revised carrying value of the old debt. Thus it was not the exchange itself which resulted in loss recognition; rather it was the act of participating in the auction process which triggered the need to write down the old debt with the written down value becoming the carryover basis of the new debt. For example, if a bank offered to exchange a loan of $100 for bonds with a face value of $70, the bank would write down
the carrying value of the tendered debt to $70 or create a reserve of $30. This accounting would be
followed regardless of whether the tendered debt was accepted for exchange in the auction. The
position that the write down was necessary notwithstanding whether the tendered debt was
accepted was based on the observation that a decision to tender was indicative of intention to
dispose of the debt prior to recovery of its carrying value at maturity. Since GAAP for banks
permits debt securities to be carried at cost only if the bank has the intention and ability to hold the
securities until their carrying value is realized by repayment at maturity, it was believed that the act
of tendering was inconsistent with a conclusion that the bank intended to hold the debt until its
maturity.

Although SAB 75 was specifically directed at providing interpretive guidance for
the Mexico/Morgan transaction, the accounting treatment discussed in SAB 75 would apply to any
transaction which was conducted through a similar auction process.

Where the terms of the exchange are the result of negotiation between the debtor
and the creditor, as in the 1990 Mexico Debt Restructuring, banks (depending upon the details of
the transaction) may be able to follow the accounting treatment described in the July 14, 1989 letter
to David Mulford, Under Secretary of Treasury from the Chief Accountant of the Securities and
Exchange Commission (SEC) (see Annex 1). Although the letter is addressed to the specifics of
the Mexico debt restructuring package, its principles are applicable to other debt restructuring
transactions that meet certain criteria, including the requirement that the terms of the exchange not
be the result of an auction.

The letter requires banks to account for both the par and the discount bonds as
FASB 15 "troubled debt restructurings," because both transactions involve a "concession granted
due to the financial difficulties of the debtor"

FASB 15 (see Annex 9) contains two methods for accounting for troubled debt
restructurings. The first method is applicable to transactions in which a disposition of the original
asset takes place. The second method is applicable when the troubled debt restructuring involves
only a "modification" of the terms of the original asset. The first method requires the fair valuing
of the new asset received. This method must be applied when the original debtor/creditor
relationship does not survive the transaction. However, even where the same debtor/creditor
relationship survives, banks may sometimes be required to fair value the asset received in the
context of a troubled debt restructuring. For example, this method was applied to the 1988
Mexican Debt Exchange Transaction (see Annex 2). In that transaction the SEC required that
banks fair value the bonds received. The SEC stated in SAB No. 75 that "since the act of
tendering debt into the auction is inconsistent with the intent and ability to hold debt "to maturity,
fair value" became the appropriate measurement basis for the debt". Therefore, either the loans
must be written down to the tender price or the allowance for loan and lease losses (ALLL) should
be increased as necessary to reduce the carrying value to the tender price.

In the July 14, 1989 letter, the SEC staff stated that the method used for accounting
for the so-called Aztec bonds issued in the 1988 Mexican Debt Exchange Transaction was not
applicable to the 1990 Mexican Debt Restructuring. The SEC staff distinguished the 1988 debt
exchange from the 1990 debt exchange on the grounds that the latter did not involve an auction
process. The SEC staff stated that accounting for the second transaction as a troubled loan
restructuring involving a modification of terms was, therefore, appropriate. Accordingly a loss is
not recognized if "the total future undiscounted cash receipts specified by the new terms of the
loan, including receipts designated as both principal and interest" are not less than the book value
of the loan. Contrary to earlier speculation that SAB 75 would apply, the SEC letter concluded that
FASB 15 permitted both types of bonds to be accepted without recognition of loss where the
criteria noted above are satisfied. Consequently, banks were able to account for both the par and
discount bonds issued in the Mexico's 1990 debt exchange without recognizing a restructuring loss.

Two important caveats to the above analysis should be noted. First, the applicability of the FASB 15 accounting for transactions that involved only a modification of the terms of the original asset does not override the continuing application of FASB No. 5 which relates to accounting for contingencies including collectibility of loans. According to FASB No. 5 banks must recognize loan losses when they are probable and reasonably estimable. If the allowance for loan and lease losses is not sufficient, an increase in the allowance through a provision for loan losses charged to income is necessary. When a specific loan is determined to be uncollectible in whole or in part, banks are required “to reduce (to ‘charge-off’) the book value of the loan to its collectible amount.” The application of FASB 15 to debt restructurings may free banks from the need to recognize losses as a result of the restructuring, but losses related to credit risk assessment and collectibility of loans identified from an assessment of the collectibility of contractual cash flows may need to be recognized to the extent that these loans are impaired or if ultimate repayment is in doubt.

Second, although banks may not need to recognize a restructuring loss upon participating in a troubled debt restructuring, the application of FASB 15 triggers strict reporting and disclosure requirements. These guidelines require the identification of the amount of loans that have been modified in troubled debt restructurings, the interest that would have been recorded at the original terms, the amount of income that was actually reported in income for the periods reported upon, and the amount of any commitments to make additional loans to the same debtors. Banks are also required to analyze any changes in their exposure. Banks may show a reduction of exposure to the extent of any written legally enforceable guarantees (by non-local third parties) and the value of any tangible liquid collateral (held and realizable by the bank outside the borrower’s country).

The analysis set forth in the SEC letter of July 14, 1989 should apply to other debt restructuring operations. Many analysts felt that SAB No. 75 discouraged some banks from participating in the 1988 Mexican Debt Exchange. The interpretation was criticized because (i) it required banks to fair value the asset received, and (ii) it required banks to write down or provision against all loans offered for exchange to the tender price. As a result of these provisions, banks were required to recognize a substantial loss, if they had not already done so, in order to participate in the auction transaction. The SEC letter of July 14, 1989 indicated that it is possible to structure transactions in such a way that commercial banks need not necessarily recognize a loss for concessions granted in the context of an appropriately structured debt restructuring. The SEC letter suggests that two requirements must be met in order to qualify for this treatment: (i) the exchange must not change the underlying debtor/creditor relationship, and (ii) the exchange must not involve an auction. Also FASB 15 requires a loss to be recognized if recorded carrying value exceeds the future interest and principal to be received.

While the above criteria provide a useful guide, it should also be remembered that the SEC has suggested that these criteria are not complete and that the appropriate treatment of a transaction will depend upon the specifics of that transaction.
Tax Treatment of Debt Reduction

**Tax Treatment of Debt Reduction Instruments: RR 89-122.**

The Internal Revenue Service (IRS) issued Revenue Ruling 89-122 (RR 89-122) (see Annex 5), in response to tax questions presented by the debt instruments issued in the context of the 1990 Mexican Financing Package.

RR 89-122 states that acceptance of either the discount bond or the par bond represents a material change in the terms of the obligation which, therefore, triggers an exchange for tax purposes. If the bond is publicly traded within 10 days of the exchange, then it must be recorded at its fair market value for tax purposes under the Internal Revenue Code and Proposed Treasury Regulations relating to original issue discount. However, if the bond is not publicly traded within 10 days of the exchange, it must be recorded, for tax purposes, at its issue price. The issue price is the lesser of (i) the face amount of the new instrument or (ii) the present value of all payments due under the instrument using the Applicable Federal Rate (AFR). In the case of a discount bond with a rate of interest lower than the AFR, the issue price would be the present value of all payments due under the instrument calculated using the AFR as the discount rate. It should be noted that Revenue Ruling 89-122 does not deal with bonds that are publicly traded. These are governed by Proposed Treasury Regulations and the Internal Revenue Code.

The distinction of whether or not the bonds were publicly traded became an important one for the purposes of the 1990 Mexican Financing Package. As a result of differences in their tax position some U.S. commercial banks wanted the bonds to be considered publicly traded. Other banks wanted the bonds to qualify for the treatment accorded bonds that are not publicly traded within ten days of the exchange. In general, banks that had U.S. income tax liability on their foreign source income wanted to book the assets received at fair market value for tax purposes i.e. they wanted the bonds to be considered "publicly traded within ten days of the exchange" in order to maximize the amount of loss recognized currently. Banks with little or no foreign income and/or excess foreign tax credits wanted the bonds to be considered "not publicly traded within ten days of the exchange" in order to defer recognition of loss.

In order to accommodate this difference in bank preferences, the menu was expanded to include two types of bonds: Type 1 (so-called "clean bonds") was designed to be publicly tradable within ten days of the exchange. Type 2 (so-called "dirty bonds") was designed so that it could not be publicly traded within ten days of the exchange.

The need to create "dirty" and "clean" instruments was also considered as an element of the Venezuelan package.

**Sourcing of Tax Losses**

Treasury Notice 89-58 required banks to allocate losses realized on the sale, exchange, or charged off of most loans (regardless of whether the borrower is foreign or domestic) between domestic and foreign sources on the basis of the proportions of loans generating domestic source income and loans generating foreign source income in the bank's loan portfolio (determined on the basis of tax book value). The press release accompanying the ruling suggested that the ruling would be reviewed after a period of time. Several analysts have interpreted the Treasury statement to imply that the ruling may be altered in the future to increase the portion of LDC losses which must be sourced as foreign. To the extent this is true, banks may have some incentive to accelerate the recognition of loss.
Repeal of Transition Rule For High Withholding Tax Interest

For taxable years beginning after December 31, 1986 interest income (other than export financing interest) subject to a foreign withholding tax or other gross basis tax of 5 percent or more is designated “high withholding tax interest” and subject to its own separate foreign tax credit limitation. A special transition rule was created for interest on loans to the “Baker 33” countries. As a result of this transition rule, the new foreign tax credit limitations were to apply to only 20% of interest received or accrued from 33 countries in 1990, to 40% of the interest received or accrued in 1991, to 65% in 1991, to 80% in 1993 and to 100% of interest received or accrued in 1994.

In the 1989 tax bill, the special transition rule for the application of the separate foreign tax credit limitation with respect to high withholding tax interest received on loans involving the Baker 33 countries was repealed. However, the repeal of the special high withholding tax interest transition rule will not apply to a taxpayer if, on any quarterly financial statement filed by such taxpayer for regulatory purposes with respect to any quarter ending during the period beginning on March 31, 1989 and ending on December 31, 1989, such statement reflects loss reserves against its portfolio of Baker 33 country loans of at least 25 percent of the amount of such loans. For example, the high withholding tax interest transition rule will continue to apply with respect to a taxpayer who satisfies the 25% loss reserves threshold on any one of its quarterly financial statements to banking regulators.

As a result of the exception to the repeal of the transition rule, the repeal of the rule probably affects none of the large U.S. banks. All of these banks seemed to be above the 25% reserve threshold. If this transition rule were repealed for any of the larger banks, it might have had a significant impact on their after-tax earnings. This bill might explain the timing of some of the reserve increases that happened at the end of fiscal year 1989.

Tax Treatment of Past Due Interest

Although no formal rulings have been issued the IRS has taken the position that interest should continue to be accrued for tax purposes even when loans have been placed on nonaccrual for accounting and regulatory purposes. The only exception to this general principle in the sovereign context has been when ATRRs have been imposed on the debt. The IRS has taken the position that the amount of interest accrued for tax purposes should be reduced to a percentage equal to one minus the ATRR applied to exposure to that country until the ATRR reaches 50% of the bank’s exposure to that country at which point interest accrual for tax purposes may cease. For example, if the ATRR is 35%, the bank should accrue at least 65% of the interest due for tax purposes even if the loan is on nonaccrual for book purposes. As soon as the ATRR reaches 50%, the bank should cease accrual for tax purposes. Table 3 below shows the illustrative amount of interest that must be accrued for tax purposes for loans to six hypothetical debtor countries (A through F).
TABLE 3

<table>
<thead>
<tr>
<th>Country</th>
<th>ATTR for Book Purposes</th>
<th>Interest Accrued for Tax Purposes</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>60%</td>
<td>0%</td>
</tr>
<tr>
<td>B</td>
<td>90%</td>
<td>0%</td>
</tr>
<tr>
<td>C</td>
<td>20%</td>
<td>0%</td>
</tr>
<tr>
<td>D</td>
<td>60%</td>
<td>0%</td>
</tr>
<tr>
<td>E</td>
<td>0%</td>
<td>85%</td>
</tr>
<tr>
<td>F</td>
<td>40%</td>
<td>0%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>15%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>60%</td>
</tr>
</tbody>
</table>

It should be noted that the tax treatment suggested in the table above is based upon the authors' interpretation of the position that IRS field officers have taken with respect to the accrual of interest for tax purposes. Some practitioners feel that the courts would reach a different result. The tax courts have yet to adjudicate disputes about the accrual of interest for tax purposes.

Other Tax, Accounting and Regulatory Issues

SEC Adoption of Rule 144A

Rule 144A (Annex 3) provides a safe harbor exemption from the registration requirements of the Securities Act of 1933 for resales of certain restricted securities to "Qualified Institutional Buyers". Prior to the adoption of Rule 144A the resale of restricted securities, including privately placed securities, was severely limited.

Rule 144A specifies several criteria that a "Qualified Institutional Buyer" must meet:

(i) the institution must in the aggregate own and invest on a discretionary basis at least $100 million in securities of issuers that are not affiliated with the institution.

(ii) if the institution is a bank or a savings and loan association then, in addition to (i) above, it must have an audited net worth of at least $25 million, as demonstrated in its latest annual financial statements.

(iii) if the institution is a registered broker-dealer the $100 million requirement stated in (i) is reduced to $10 million. No requirement with regard to the ownership of, or investment in, securities applies to registered broker-dealers purchasing as riskless principal for, or acting as agent on a non-discretionary basis in, a sale to Qualified Institutional Buyers.

Rule 144A also provides that the only securities which may be resold in reliance on the Rule are restricted securities that, when issued, are not of the same class as securities listed on a U.S. securities exchange or quoted on NASDAQ.

The registration requirements of the Securities Act of 1933 were designed to protect unsophisticated investors by requiring that offers of securities be registered and that certain information about the securities be provided to regulatory agencies and to prospective buyers. Rule 144A acknowledges that certain classes of institutional investors can fend for themselves and do not require the protections afforded by the registration requirements of the Securities Act of 1933.
In addition to allowing the institutions that meet the above criteria to purchase certain restricted securities, the SEC, in the Rule 144A adopting release, modified the position regarding the illiquidity of restricted securities insofar as it relates to securities eligible for sale under Rule 144A, and as a result provided some relief to open-end funds subject to the SEC's prior interpretation imposing a 10% limit on investments eligible for resale under Rule 144A in illiquid securities. The SEC has determined that restricted securities are not *per se* illiquid and that the question of liquidity is a question of fact to be determined by or under the direction of the investor's board of directors.

Although Rule 144A is aimed at encouraging foreign issuers to use the U.S. private placement market, the SEC is still concerned that investors, even institutional investors, receive adequate information. Therefore, the Rule requires that the holder and prospective purchasers of the restricted securities to be resold in reliance on the Rule must have the right to obtain from the issuer, upon request, certain information regarding the issuer, including basic financial information similar to the information the issuer would provide in its home country. This information requirement applies only to issuers that are not reporting under the Exchange Act of 1934, foreign issuers that are not exempt from reporting pursuant to Rule 12g3-2(b) and foreign governments not eligible to register securities on Schedule B of the Securities Act of 1933.

**OCC Regulation 12 CFR Section 32.5(d)(3) (see Annex 4)**

Lending limits have occasionally been cited by some banks as obstacles to further lending to countries in which some banks have large exposures. However, in practice lending limits do not appear to have been important obstacles to debt restructurings or new money packages. In fact, regulators seem to have made efforts to interpret the lending limit statute, 12 USC84, to accommodate the outcomes of negotiations between commercial banks and debtor countries as much as possible. The basic credit limitation rules and some of the ways in which these rules have been modified to accommodate debt restructurings are reviewed in Annex 8. The amendment of the OCC's lending limit regulation, 12 CFR 32, to add a new section establishing that borrowers need not be combined when the debt of certain public sector borrowers is consolidated in the context of a debt restructuring, continues this pattern of accommodation. Ruling 90-2 was issued in response to questions raised by the 1990 Mexican Debt Restructuring.

In 1982, the United States Congress amended 12 U.S.C. 84 to raise the basic limit on a national bank's lending to a single borrower from ten to fifteen percent of the bank's unimpaired capital and unimpaired surplus. Rules concerning the combination of loans to separate borrowers were eliminated from the statute to permit the OCC maximum flexibility in developing regulations on this subject. Pursuant to its statutory power, the OCC issued a rule which stated that the general rules for combining loans to separate borrowers are not applicable to loans to foreign governments, their agencies and instrumentalities. Instead such loans are combined with one another only if the borrower fails to meet a two-part test (the "means and purpose test"). Under this test loans to foreign governmental entities are not consolidated for lending limit purposes if (i) the borrower has revenue of its own sufficient to service its loans, and (ii) the purpose of the loan is consistent with the borrower's own general business. Loans made to a foreign central government, its political subdivisions, its agencies, and its instrumentalities are not combined for lending limit purposes as long as the means and purpose test is met.

In the context of the 1990 Mexican Financing Package the commercial bank debt of many public sector obligors was consolidated under one central obligor, the Mexican central government. Many of these public sector obligors met the means and purpose test. Consequently, some commercial banks were concerned that the consolidation of the public sector debt under one obligor might result in their exceeding the lending limit to the central obligor. Section 32.5(d)(3)
allays these concerns. It states the appropriate regulatory response to a situation such as that presented in the 1990 Mexican Financing Package is to “look through” the technical consolidation of loans, which occurs in sovereign debt restructurings, and to continue to treat the loans as loans outstanding to their original obligors for purposes of the lending limit of 12 U.S.C. 84. As a result, the restructured loans will not be combined under the lending limit of the new central obligor.

Section 32.5(d)(3) states that loans to a foreign government qualify for this non-combination treatment only if the consolidation of loans occurs in a restructuring that the Comptroller has approved for this lending limit treatment. The factors that the Comptroller will use in making this determination include, but are not limited to, the following:

(i) whether the restructing involves a substantial portion of the total external commercial bank loans outstanding to the foreign government, its agencies, and instrumentalities and a substantial number of the country's external commercial bank creditors;

(ii) whether the restructuring and consolidation under a central obligor is being done primarily to facilitate external debt management; and

(iii) whether the restructuring includes features of debt or debt-service reduction.

Section 32.5(d)(3) states that it is intended to address restructurings of foreign sovereign debt into which the foreign government is entering to manage its external debt. The Rule states that this treatment will not be given in other situations, "such as loan consolidations stemming from changes in the underlying economic relationship between previously separate borrowers."

Tax and Regulatory Treatment of Specific Instruments

**Discount Bonds**

The accounting and regulatory treatment of discount bonds depends upon whether or not the exchange of loans for bonds is effected through an auction process, through an exchange of assets in which the original debtor/creditor relationship is changed or in a restructuring which qualifies as a modification of terms. If the restructuring is effected in an auction process or an exchange which is not a modification of terms, a loss will be recognized if the fair value of the new securities is less than the carrying value of the old debt, and the new securities received in the exchange will be recorded at fair value. If the exchange is a modification of terms, no loss is recognized. In order for a restructuring to qualify as a modification of terms the exchange (1) may not involve an auction process, (2) may not alter the credit/debtor relationship, and (3) must involve concessions due to the debtor’s distressed financial condition. It is likely that future sovereign debt restructurings will be structured in order to ensure that the FASB 15 criteria for modification of terms accounting are met.

With respect to disclosure of foreign exposure, banks will be permitted to reduce their reported exposure to the debtor country by an amount equal to any losses that are recorded in booking the new asset plus the current value of the specified collateral.

As described above, the tax treatment of the bond will depend upon whether or not the bond is publicly traded within ten days of the exchange. If it is publicly traded, then the bond is treated as issued at fair market value for tax purposes. If it is not publicly traded and it carries a market rate of interest which is equal to or exceeds the Applicable Federal Rate, then the bond's
issue price would be equal to its face value. If it is not publicly traded and the interest rate is less than the AFR, the bond is treated as issued for an amount equal to the present value of all payments due under the bond (discounted at the AFR). In any case, the bank would be allowed to deduct the difference between its tax basis in the original loan and the issue price of the bond.

One area of uncertainty in the treatment of discount bonds is the need for reserves after a debt restructuring has taken place. U.S. regulators recognize that a debt restructuring changes the risk of non-payment on credits to the debtor country. This change in the risk of non-payment should be recognized both with respect to mandated specific reserves (i.e. ATRRs) and discretionary or general reserves. It remains uncertain how reserve policies will be modified to take into account the improved nature of the credit. Some regulators have informally suggested that no ATRRs should be required against instruments received in the context of a debt reduction operation if the country continues to service the debt instruments regularly for a reasonable period of time. The attitude that regulators finally take on this issue may be of some significance for countries trying to regain access to international capital markets. It must be noted, however, that application of FASB 15 does not obviate the need for a FAS 5 collectibility assessment.

**Par Bonds**

The regulatory and accounting treatment of the par bond is the same as for a discount bond. As in the case of the discount bond, it will be necessary to determine whether SAB 75 or FASB 15 governs the accounting for the transaction. If it is determined that FASB 15 governs the transaction it will be necessary to determine whether the new asset involves only a "modification" of the terms of the original loan, in which case no restructuring loss need be recognized if the undiscounted contractual cash receipts are at least equal to the book value of the original loan. If the new asset involves more than a "modification" of the terms of the original loan, the asset must be fair valued for book purposes.

If SAB 75 governs the accounting for the transaction, the troubled debt tendered for exchange would also have to be written down to its fair value. It would be reasonable to conclude that this would be no lower than the fair value of the instrument tendered for the troubled debt. However, the par value of either instrument would not be relevant -- only their fair values.

The bank's reported exposure to the debtor country will be reduced to the extent of any write-offs recorded in accepting the new instrument and by an amount equal to the current value of any collateral attached to the new instruments.

As in the case of the discount bond, the tax treatment of the par exchange is governed by IRS Ruling 89-122, the Internal Revenue Code and Proposed Treasury Regulations. If the bond is considered to be publicly traded, a par bond is treated as issued for an amount equal to its fair market value for tax purposes. If the bond is not considered to be publicly traded and the stated interest rate is lower than the Applicable Federal Rate, then the issue price of the bond must be calculated by discounting the expected cash receipts by the AFR. If the bond is not considered to be publicly traded and it carries an interest rate that equals or exceeds the AFR, then the issue price of the bond is equal to its face value. Banks would be allowed to deduct the difference between their tax basis in the original loan and the issue price of the new instrument. If the issue price of the new instrument is higher than the bank’s tax basis in the original loan (an unlikely event) then banks would be required to recognize a taxable gain upon acceptance of the new instrument.

For banks that are interested in minimizing their tax losses, a non-publicly traded bond may be best from a purely tax point of view. For banks that are interested in maximizing their tax losses, a publicly traded bond may minimize tax liability.
As in the case of the discount bond, it remains uncertain how the need for specific mandated ATRRs and discretionary general reserves should be evaluated with respect to the instruments received in the context of a debt reduction operation.

**Buybacks**

The tax, accounting and regulatory treatment of buybacks is straightforward. For tax purposes a loss must be recorded equal to the difference between the bank's tax basis in the original loan and the value of the cash received. For book purposes a loss would be recognized equal to the difference between the book value of the original loan and the value of the cash received.

**New Money**

In general, new money would be treated the same as existing loans. The one exception to this treatment is that U.S. regulators have stated that they would not necessarily require ATRRs against new money loans even if the loans are made to countries where ATRRs have been imposed on existing loans. This treatment of new money loans would not necessarily be a precedent for the similar treatment of other debt instruments accepted in the context of a debt reduction operation. This would be a facts and circumstances decision integrally based on the debtor's capacity to pay.

**Interest Capitalization**

Although the tax and regulatory treatment of interest capitalization remains very uncertain, it is likely that this issue will need to be addressed as a policy issue in the context of future debt restructuring operations that may involve capitalization of interest. In the United States no categorical distinction is made between the capitalization of past due interest and an agreement to capitalize future interest payments. For book purposes, the question in both cases is whether the borrower is creditworthy. If the borrower is not creditworthy, then it is unlikely that regulators and accountants would allow banks to recognize the income received.

However, this general rule becomes problematic in the context of debt reduction operations. We understand that both the AICPA Bank Committee and the Accounting Committee of the New York Clearing House Association are addressing the proper treatment of payment of past due interest, (both in cash and new debt instruments), when received as part of an overall troubled debt restructuring. It appears that if the debtor is unable to pay principal and interest timely under the terms of the original instrument, the issuance of more paper in lieu of cash interest would not improve the position of the creditor. Thus, if it was inappropriate to accrue interest income on the original troubled debt, the receipt of additional paper from the troubled borrower would probably also not be recognized as income.

The tax treatment of interest capitalization is equally unclear. As described above, the IRS field officers have reportedly taken the initial position that the presence of an ATRR may affect the need for banks to accrue income for tax purposes.\(^\text{18}\) The IRS has taken the position that the presence of a 10% ATRR should reduce the accrual of income for tax purposes by an equal percentage. They have stated that this rule should be followed until the ATRR reaches the 50% level at which point income recognition for tax purposes should cease. It is possible that the IRS would take the same position with respect to the notes received in exchange for interest arrears by

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\(^{18}\) Note that the position of the field officers should not be taken as representing the final position of the IRS, let alone a definitive statement of the law.
allowing banks to not accrue the notes for tax purposes to the extent that regulators mandate ATRRs on the note. This position does not necessarily follow from their current treatment of interest accrual. Interest capitalization could be distinguished on a number of grounds. It is likely that this issue will have to be resolved before it will be possible to structure transactions involving the resolution of substantial interest arrears through the issuance of new debt instruments to commercial banks.

**Interest vs. Principal Enhancement**

With regard to reserve requirements, it seems there would be a difference in the treatment of instruments with enhanced principal and instruments with enhanced interest payments. As reserves provide for the risk of loss in recorded balances, the level of enhancements associated with recorded principal would be an important factor in determining the reserve requirements.

With respect to capital adequacy requirement, there is some difference in the way that the Basle guidelines apply to interest and principal credit enhancements. The guidelines make a distinction between acceptable collateral and guarantees. In the case of collateral a lower risk weight would be applied to that portion of the principal which is secured by the current market value of collateral. In the case of guarantees, the lower risk weight would be applied to the portion of the principal which is guaranteed.
## United States

### Matrix of Regulatory and Tax Treatment of Different Financial Instruments

<table>
<thead>
<tr>
<th>Instrument</th>
<th>Accounting Treatment</th>
<th>Tax Treatment</th>
<th>Regulatory Treatment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reduced Rate Loan</td>
<td>Variable.</td>
<td>May or may not be realized depending on terms of restructuring.</td>
<td>Follows accounting treatment. If no loss is recognized, none is recognized for regulatory purposes. Risk-weight is 100% unless asset is guaranteed or collateralized.</td>
</tr>
<tr>
<td>Par Bond</td>
<td>If no auction, and no change in debtor/creditor relationship, no loss is recognized, must be accounted for as FASB 15 Troubled Debt Restructuring and disclosed. Otherwise, the new assets received in the exchange must be carried at fair market value. Loss charged to LLRs if they exist. If no LLRs exist, the loss is charged to income.</td>
<td>IRS Ruling 89-12 applied. If not publicly traded, then calculated new basis using AFR, if AFR is less than stated interest rate. It publicly traded bond would probably be fair valued.</td>
<td>Follows accounting treatment. If no loss is recognized for book purposes, none is recognized for regulatory purposes. Risk-weight is 100% unless asset is guaranteed or collateralized.</td>
</tr>
<tr>
<td>Discount Bond</td>
<td>Same as par bond.</td>
<td>Same as par bond.</td>
<td>See accounting treatment.</td>
</tr>
<tr>
<td>Debt/Equity Conversion</td>
<td>Must be accounted for at fair value. Calculation of fair value may be complicated.</td>
<td>Certain that fair value method would be employed but measurement of fair value may be difficult.</td>
<td>Converted loan subtracted from country exposure for purposes of mandatory reserving. Fair value accounting used.</td>
</tr>
<tr>
<td>Buyback</td>
<td>Loss must be recognized equal to difference between existing book value and cash received. Loss charged to LLRs.</td>
<td>Loss allowed equal to difference between old tax basis and cash received.</td>
<td>Loss recognized equal to difference between old regulatory value and cash received.</td>
</tr>
<tr>
<td>New Money</td>
<td>Accounted for at face value with LLRs as determined by management.</td>
<td>LLRs are not tax deductible.</td>
<td>LLRs currently included in regulatory capital.</td>
</tr>
<tr>
<td>Interest Capitalization</td>
<td>No income may be recognized on capitalized interest. Interest not capitalized continues to be recognized as cash is received as long as the recorded principal is fully collectible.</td>
<td>Uncertain.</td>
<td>Same as accounting treatment OCC EC No. 229.</td>
</tr>
<tr>
<td>Conversion into</td>
<td>Fair value accounting.</td>
<td></td>
<td></td>
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<td>----------------</td>
<td>------------------------</td>
<td></td>
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<tr>
<td>Local Currency</td>
<td>Issue price of new loan</td>
<td></td>
<td></td>
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<tr>
<td>Loan at Current</td>
<td>(in dollars) used to</td>
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<tr>
<td>Exchange</td>
<td>determine if a change in</td>
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<td></td>
<td>tax basis has taken place</td>
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<td>and loss has been</td>
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<td>realized.</td>
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<td>Fair value accounting</td>
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<td>subtracted from country</td>
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<td>exposure for purposes of</td>
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<td>calculating mandatory LLR</td>
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<td>requirements if denominated and</td>
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<td></td>
<td>funded in local currency.</td>
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</tbody>
</table>
U.S.

ANNEX 1: Letter from S.E.C. to Mr. Mulford, US Department of Treasury

July 14, 1989 Letter to David Mulford

July 14, 1989

The Honorable David C. Mulford
Under Secretary of Treasury
U.S. Department of Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Dear Dr. Mulford:

At your request, attached is a brief analysis of the accounting and disclosure required in any adjustment of LDC debt. This analysis, dated July 14, 1989, was prepared by the staffs of the Office of the Chief Accountant and Division of Corporation Finance of the Securities and Exchange Commission based on existing accounting standards and SEC literature. This analysis does not represent a rule or interpretation nor does it bear the Commission's official approval.

We are pleased to provide you with this analysis. Please call if you need any further advice or assistance or should you have any questions.

Sincerely,

Edmund Coulson  Linda C. Quinn
Chief Accountant  Director
Division of Corporation Finance

Enclosure
SECURITIES AND EXCHANGE COMMISSION
STAFF MEMORANDUM
ACCOUNTING AND DISCLOSURE ISSUES INVOLVED IN LDC DEBT RESTRUCTURINGS

The following memorandum was prepared by staff of the Division of Corporation Finance and Office of Chief Accountant of the Securities and Exchange Commission for submission to the U.S. Department of the Treasury in response to Treasury's request for information regarding accounting and disclosure issues involved in proposed LDC debt restructurings undertaken because of financial difficulties of the debtors.

Background

The staff understands that two basic debt restructuring transactions are being considered as part of International Monetary Fund or multilateral development bank adjustment programs offering some form of official financial support. The staff further understands that the quality of the restructured loans are expected to be enhanced as a result of these programs. In practice there could be variations, which, as discussed subsequently in this memorandum, may produce different accounting and disclosure results. For illustrative purposes, we will assume that in both transactions the principal of the new instrument would be due in full in 30 years, and the funds for collateral and support arrangements would come from non-bank sources:

1. The first transaction would involve banks exchanging debt for a new debt instrument at a discount and a market rate of interest. Principal of the new instrument would be fully collateralized at maturity, and interest payment support would be provided. If the interest support were not utilized in the first year, it would then roll forward to the following year and would continue in effect in succeeding years until utilized, or for 10 years, whichever occurred first.

2. The second transaction would involve banks exchanging debt for a new debt instrument with the same face amount, but with a below market rate of interest. There would be interest payment support identical to that in the first transaction.

As discussed below, the staff believes both of these transactions must be accounted for as "troubled debt restructurings" because they involve concessions granted due to the financial difficulties of the debtor. The accounting for these transactions is contained in FASB Statement of Financial Accounting Standards (FAS) No. 15, "Accounting by Debtors and Creditors for Troubled Debt Restructurings". Additionally, the accounting for the debt both before and after the restructuring must be in accordance with provisions of FAS No. 5, "Accounting for Contingencies".19

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19 In addition, bank holding company disclosures relating to debt restructurings must be made in accordance with FAS No. 15 and FAS No. 5 and with Securities and Exchange Commission Regulation S-K, and particularly Industry Guide 3, "Statistical Disclosure by bank Holding Companies" (Regulations S-K 801(c) and 802(c)).
As a result of the interplay of these two standards, different accounting and disclosures would result depending upon the facts and circumstances relating to the terms of the restructuring and the lender's judgment regarding the debt.

**Accounting Issues to be Considered in any Adjustment of LDC Debt**

**Adjustment to Terms of Debt** -- If, in a negotiated transaction where the same debtor/creditor relationship survives, LDC creditors accept new terms on debt which reduce the principal amount of the debt or reduce the interest rate below current market interest rates, the transaction would be accounted for as a "troubled debt restructuring."

FAS No. 15 requires the following accounting for troubled debt restructurings involving modification of terms. Whether a loss is required to be recognized depends on a comparison of the total future cash flows called for by the new terms with the book value of the old loan. Book value is defined as the face amount increased or decreased by accrued interest, premium, discount and charge-offs.

**Loss Not Recognized** --

If the total future undiscounted cash receipts specified by the new terms of the loan, including receipts designated as both principal and interest, equal or exceed the book value or the loan, no loss is recognized at the time of the restructuring.

**Loss Recognized** --

If the total future undiscounted cash receipts specified by the new terms of the loan, including receipts designated as both principal and interest, are less than the book value of the loan, a loss must be recognized at the time of the restructuring in the amount of any such deficit.

Accordingly, under FAS No. 15, if the cash receipts called for by the new terms exceed the book value of the old loan, the creditor may either reduce the interest rate or forgive some of the principal or interest owed by a debtor (or do both) without triggering a requirement that the creditor record an immediate loss in its financial statements.

If undiscounted cash flows specified by the new terms equal or exceed the book value of the old loan, future interest income to be recorded on the loans would be limited to the amount of the excess of cash flow (whether principal or interest) over book value. This interest income would be recorded at an amount each year that would result in a constant effective interest rate.

If a write down is required because the undiscounted cash flows specified by the new terms do not equal or exceed book value, no future income would be recorded on that loan and all future receipts would be treated as a recovery of book value.

While FAS 15 modification of terms accounting is required for negotiated troubled debt restructurings whenever the same debtor/creditor relationship survives, certain other restructuring transactions must be accounted for based on fair value of the instruments involved. For example, in the 1988 Mexican Debt Exchange transactions, the staff indicated in Staff Accounting Bulletin No. 75 that banks that tendered Mexican debt in the auction process must recognize losses based on fair value, since the act of tendering debt into the auction was an act inconsistent with the intent and ability to hold debt, resulting in fair value becoming the appropriate measurement basis for the debt.
Reserve and Charge-Offs Under FAS No. 5 -- FAS No. 15 does not override the continuing application of the provisions of FAS No. 5, which requires management at each reporting date to assess the ultimate collectibility of the book value of all loans and to recognize any resulting loss in the portfolio.

Reserves for probable and reasonably estimable losses in the entire portfolio are customarily provided by reducing net income but without allocating expected losses to a specific loan account.

When a specific loan is determined to be uncollectible in whole or in part, a bank is required to reduce (to "charge-off") the book value of the loan to its collectible amount. For financial reporting purposes a charge-off need not necessarily impact net income. If an existing reserve for losses established in prior periods had included an estimated amount related to a specific loan subsequently written off, the charge-off could merely reduce the reserve and would not affect current income.

In any event, the need for reserves and charge-offs would be limited to the amount of book value of the debt in excess of the ultimate amount of any collateral, guarantee or other third party enhancement (assuming there are no uncertainties related to such collateral or third party enhancement).

When an individual bank charges-off restructured loans of a particular country due to doubts about collectibility, it must carefully analyze the need to increase its reserves or record further charge-offs for any remaining portfolio of loans from that country, and it should be able to demonstrate the reasons for its conclusions. Among the factors a bank must consider are: (1) the intent and ability of the country to service its debt, (2) whether the restructuring transaction, which may be done in conjunction with IMF loans and multilateral development bank structural adjustment lending programs, will enhance the debtor country's ability to service any non-restructured loans and any new loans, and (3) the debt classification by the bank regulatory agencies.

Additionally, if a bank determines it does not have the intent or ability to hold a loan to maturity, it must write the loan down to its market value and recognize any further market declines until that loan is sold or repaid.

It is the responsibility of individual banks (subject to review by their independent accountants) to make these judgments.

Disclosure -- FAS No. 15 and Industry Guide 3 require identification of the amount of loans that have been modified in troubled debt restructurings, the interest that would have been recorded at the original terms, the amount of income that was actually reported in income for the periods reported upon, and the amount of any commitments to make additional loans to the same debtors. This disclosure is required if a reported yield subsequent to restructuring is less than current market rate. If a reported yield is equal to or greater than a market yield, a loan whose terms have been modified need not be included in that disclosure (except in the year of restructuring).

Industry Guide 3 also specifically requires information about a bank's LDC exposure, including an analysis of changes therein. Banks may show a reduction of exposure to the extent of any written legally enforceable guarantees (by non-local third parties) and the value of any tangible liquid collateral (held and realizable by the bank outside the borrower's country).
Acceptable alternative forms of presentation for collateral whose fair value differs from its face value are included in Staff Accounting Bulletin No. 75.

**Other Features May Produce Different Results**

The above discussion is necessarily general. The ultimate accounting and disclosure ramifications will depend on a careful analysis of the specific terms and features of any final transaction. In this connection, it should be emphasized that certain features added to an otherwise "plain-vanilla" modification of terms of a loan can result in significantly different accounting results.

For example, FAS No. 15 indicates that a modification of the terms of debt where the same debtor/creditor relationship is maintained is a transaction that may not result in the recognition of a loss. However, it also indicates that if a new debtor, unrelated to the previous debtor, assumes the obligations of the original debtor or is added as a joint debtor, the debt of the new debtor must be recorded at its fair value on the books of the creditor. A loss (or gain) to the creditor would result equal to the difference between the book value of the old debt and the fair value of the consideration received.

FAS No. 15 provides for similar accounting for a transfer of assets to the creditor, including a cash buy-back of loans, in full satisfaction of the existing obligation. If an auction process were added to the restructuring transactions, that also would result in recognition of a loss based on fair value. Finally, certain features, such as restructuring terms that include contingent payments, may result in a higher likelihood of a FAS No. 15 loss (based on total cash payments specified by the new terms).

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21 See footnote # 2 above.
U.S.

ANNEX 2

Staff Accounting Bulletin Number 75

SECURITIES AND EXCHANGE COMMISSION AGENCY:
Securities and Exchange Commission.

17 CFR Part 211
Staff Accounting Bulletin No. 75

[Release No. SAB 75]

53 FR 865

January 4, 1988

ACTION: Publication of staff accounting bulletin.
SUMMARY: This staff accounting bulletin expresses the staff's views regarding certain accounting and disclosure issues relevant to a proposed Mexican Debt Exchange transaction.

DATES:

FOR FURTHER INFORMATION CONTACT: Jeffrey C. Jones, Office of the Chief Accountant (202/272-2130); or Howard P. Hodges, Jr., Division of Corporation Finance (202/272-2553), Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549.

TEXT:
SUPPLEMENTARY INFORMATION: The statements in staff accounting bulletins are not rules or interpretations of the Commission nor are they published as bearing the Commission's official approval. They represent interpretations and practices followed by the Division of Corporation Finance and the Office of the Chief Accountant in administering the disclosure requirements of the Federal securities laws.

Jonathan G. Katz,
Secretary

January 4, 1988

PART 211 -- [AMENDED]

Part 211 of Title 17 of the Code of Federal Regulations is amended by adding Staff Accounting Bulletin No. 75 to the table found in Subpart B.

Staff Accounting Bulletin No. 75
The staff hereby adds Sub-Section 2 to Topic 11.H of the staff accounting bulletin series. Topic 11.H.2 discusses the staff's views regarding certain accounting and disclosure issues relevant to a proposed Mexican Debt Exchange transaction.

Topic 11: Miscellaneous Disclosure

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H. Disclosures by Bank Holding Companies Regarding Certain Foreign Loans

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2. Accounting and Disclosures by Bank Holding Companies for a "Mexican Debt Exchange" transaction.

Facts: Inquiries have been made of the staff regarding certain accounting and disclosure issues raised by a proposed “Mexican Debt Exchange” transaction which could involve numerous bank holding companies with existing obligations of the United Mexican States (“Mexico”) or other Mexican public sector entities (collectively, “Existing Obligations”). The key elements of the Mexican Debt Exchange are as follows:

Mexico will offer for sale bonds (“Bonds”), denominated in U.S. dollars, which will pay interest at a LIBOR-based floating rate and mature in twenty years. Mexico will undertake to list the Bonds on the Luxembourg Stock Exchange. The Bonds will be secured, as to their ultimate principal value only, by non-interest bearing securities of the U.S. Treasury (“Zero Coupon Treasury Securities”) which will be purchased by Mexico. The Zero Coupon Treasury will be pledged to holders of the Bonds and held in custody at the Federal Reserve Bank in New York and will have a maturity date and ultimate principal value which match the maturity date and principal value of the Bonds. While the Bonds will have default and acceleration provisions, the holder of a Bond will not be permitted to have access to the collateral prior to the final scheduled maturity date, at which time the proceeds of the collateral will be available to pay the full principal amount of the Bonds. As such, the holder of a Bond ultimately will be secured as to principal at maturity; however, the interest payments will not be secured. The Bonds will not be subject to future restructurings of Mexico’s Existing Obligations, and Mexico has indicated that neither the Bonds nor the Existing Obligations exchanged therefore will be considered part of a base amount with respect to any future requests by Mexico for new money.

The Mexican Debt Exchange will be structured in such a way that potential purchasers of the Bonds will submit bids on a voluntary basis to the auction agent. These bids will specify the face dollar amount of existing restructured commercial bank obligations of Mexico or of other Mexican public sector entities that the potential purchaser is willing to tender and the face dollar amount of Bonds that the purchaser is willing to accept in exchange for the Existing Obligations. Following the auction date, Mexico will determine the face dollar amount of Bonds to be issued and will exchange the Bonds for Existing Obligations taking first the offer of the largest face dollar amount of Existing Obligations per face dollar amount of Bonds, and so on, until all Bonds which Mexico is willing to issue have been subscribed. It is therefore possible that greater amount of Existing Obligations could be tendered than Mexico is willing to accept.

Question 1: How should the Mexican Debt Exchange transaction be accounted for?

Interpretive Response: GAAP allows loans to be carried at historical cost only if the holder has both the intent and ability to hold the loans to maturity. The staff believes that tendering Existing Obligations to the auction agent is inconsistent with an intent to hold such
tendered loans to maturity. Accordingly, the tender of the obligations is an event that must be
given accounting recognition either (i) by writing the loans down to the price at which the bank has
agreed to accept Bonds in the tender (tender price) or (ii) by increasing as necessary the allowance
for loan losses to an amount sufficient to result in a net carrying value for the loans tendered that
equals the tender price.

Under the second approach, the staff believes that at the tender date, management
has a responsibility to assess the allowance for losses relative to its LDC portfolio to determine if it
is sufficient to result in a net carrying value for the loans tendered which is the same as the tender
price. If it is not sufficient, an increase in the allowance through a provision for loans losses
charged to income is necessary. Disclosure of the amount and nature of any change to the
allowance or the reasons why one is not considered necessary should be made.

Under the second approach, at the date the Existing Obligations are accepted by
Mexico and the bank receives the Bonds, the Existing Obligations accepted should be removed as
an asset from the balance sheet, the fair value of the Bonds received should be recorded as an
asset, and the allowance for losses should be reduced by the difference between these two
amounts.

Of course, pursuant to Statement of Financial Accounting Standards No. 5,
"Accounting for Contingencies," management has a continuing responsibility to assess the
adequacy of the allowance for loan losses relative to the Mexican debt not tendered and the
remaining LDC portfolio to insure that the allowance is adequate to provide for losses due to
ultimate collectibility including anticipated losses from sale, swap or other exchange of loans.

Question 2: What financial statement and other disclosure issues
regarding the Mexican Debt Exchange and the Bonds received should be
considered by registrants?

Interpretive Response: The staff believes that disclosure of the nature of the
transaction would be necessary, including:

-- Carrying value and terms of Existing Obligations exchanged;

-- Face value, carrying value, market value and terms of Bonds received;

-- The effect of the transaction on the allowance for loan losses and the provision for
losses for the current period; and

-- Annual interest income on Existing Obligations exchanged and annual interest
income on Bonds received.

-- On an ongoing basis, the staff believes that the terms, carrying value and market
value of the Bonds should be disclosed, if material, due to their unique features.

Question 3: What disclosure with respect to the Bonds received would
be acceptable under Industry Guide 3?

Interpretive Response: Instruction (4) to Item III.C.3. of Industry Guide 3 states:
"The value of any tangible, liquid collateral may also be netted against cross-border outstanding of
a country if it is held and realizable by the lender outside of the borrower's country. "Given the
unique features of the Bonds in that the ultimate repayment of the principal amount (but not
interest) at maturity is assured, the staff will not object to either of two presentations. Under the
first presentation, the carrying value of the Bonds, including any accrued but unpaid interest, would be included as a "Cross-border outstanding" to the extent it exceeds the current fair value of the Zero Coupon Treasury Securities which collateralize the bonds. Alternatively, under the second presentation, the carrying value of the bond principal would be excluded from Mexican cross-border outstandings provided (a) disclosure is made of the exclusion, (b) for purposes of determining the 1% and .75% of total assets disclosure thresholds of Item III.C.3. of Industry Guide 3, such carrying values are not excluded, and (c) all the Guide 3 disclosures relating to cross-border outstandings continue to be made, as discussed further below.

For registrants that adopt the alternative disclosure approach and whose Mexican cross-border outstandings (excluding the carrying value of the Bond principal) exceed 1% of total assets, appropriate footnote disclosure of the exclusions should be made. Such footnote should indicate the face amount and carrying value of the Bonds excluded, the market value of such Bonds, and the face amount and current fair value of the Zero Coupon Treasury Securities which secure the Bonds.

If the Mexican cross-border outstandings (excluding the carrying value of the Bond principal) are less than 1% of total assets but with the addition of the carrying value of the Bond principal would exceed 1%, the carrying value of the Mexican cross-border outstandings may be excluded from the list of countries whose cross-border outstandings exceed 1% of total assets provided that a footnote discloses the amount of Mexican cross-border outstandings (excluding the carrying value of the Bond principal) along with the footnote-type disclosure concerning the Bonds discussed in the previous paragraph. This disclosure and any other material disclosure specified by Item III.C.3. of Industry Guide 3 would continue to be made as long as Mexican exposure, including the carrying value of the Bond principal, exceeded 1%.

If Mexican cross-border outstandings (excluding the carrying value of the Bond Principal) are less than .75% of total assets but with the addition of the carrying value of the Mexican Bond principal would exceed .75% but be less than 1%, cross-border outstandings disclosed pursuant to Instruction (7) to Item III.C.3 of Industry Guide 3 may exclude Mexico provided a footnote is added to the aggregate disclosure which discloses the amount of Mexican cross-border outstandings and the fact that they have not been included. The carrying value of the Bond principal may be excluded from the amount of Mexican cross-border outstandings disclosed in the footnote provided the footnote-type disclosure discussed in the second preceding paragraph is also made.

In essence, the alternative discussed herein results in a change only in the method of presenting information, not in the total information required.\(^{22}\)

The appropriate disclosure would depend on the level of Mexican cross-border outstandings as follows:

A. Assuming that the remaining Mexican cross-border outstandings are in excess of 1% of total assets:

\(^{22}\) The following represents proposed disclosure using the alternative method discussed above. Of course, it would be necessary to supplement this disclosure with the additional disclosures regarding foreign outstandings that are called for Guide 3 (e.g., an analysis of the changes in aggregate outstandings), and the disclosures called for by the Interpretive Responses to Questions 1 and 2.
Mexican cross-border outstandings (which excludes the total amount if the carrying value of Bond principal) would be disclosed in the table presenting all such outstandings in excess of 1%.

Proposed footnote disclosure --

Not included in this amount is $________ million of Mexican Government Bonds maturing in 2008, with a carrying value of $________ million [if different from face value]. These Mexican government Bonds had a market value of $________ million on [reporting date].

The principal amount of these bonds is fully secured, at maturity, by $________ million face value of U.S. Zero Coupon Treasury Securities that mature on the same date. The current fair value of these U.S. Government securities is $________ million at [reporting date]. This collateral is pledged to holders of the bonds and held in custody at the Federal Reserve Bank of New York.

The details of the transaction in which these bonds were acquired was reported in the Corporation's Form (8-K, 10-Q or 10-K for [date]). Accrued interest on the bonds, which is not secured, is included in the outstandings reported [amount to be disclosed if material]. Future interest of the bonds remains a cross-border risk.

B. Assuming that remaining Mexican cross-border outstandings are less than 1% of total assets but with the addition of the carrying value of the Mexican Bond principal would exceed 1%:

-- There would not be any disclosure included in any cross-border table.

-- The total amount of remaining cross-border Mexican outstandings would be disclosed in footnote to the table. Such footnote would also explain that the Mexican outstandings are excluded from the table.

-- Additional footnote disclosure -- (same disclosure in A above).

-- The disclosure required under this paragraph (plus any other disclosure required by Item III.C.3 of Guide 3) would continue so long as Mexican exposure, including the carrying value of the Mexican Bond principal, exceeded 1%.

C. Assuming that the remaining Mexican cross-border outstandings is less than .75% of total assets but with the addition of the carrying value of the Mexican Bond principal is greater than .75% but less than 1%:

-- Mexico would not be included in the list of names of countries required by Instruction 7 to Item III.C.3 of Industry Guide 3 and the amount of Mexican cross-border outstandings would not be included in the aggregate amount of outstandings attributable to all such countries.

-- A footnote would be added to this disclosure of aggregate outstandings which discusses the Mexican outstanding and the Mexican Bonds. An example follows:

Not included in the above aggregate outstandings are the Corporation's cross-border outstanding to Mexico which totalled $________ million at [reporting date]. This amount
is less than .75% of total assets. (The remaining portion of this footnote is the same disclosure in A above.)

D. Assuming that the total of the Mexican cross-border outstandings plus the carrying value of the Bond principal is less than the .75% of total assets:

-- No disclosure as in A above would be provided if any other aspects of the financial statements are materially affected by this transaction (such as the allowance for loan losses).

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Changes in aggregate outstandings to certain countries experiencing liquidity problems are required to be presented in tabular form in compliance with Instruction (6) (b) to Item III.C.3. In this table, Existing Obligations exchanged for the Bonds would generally be included in the aggregate cross-border outstandings at the beginning of the period during which the exchange occurred. For registrants using the alternative method, the amount of Existing Obligations which were exchanged would be included as a deduction in the “other changes” caption in the table. In addition, a footnote will be provided to the table as follows:

-- Relates primarily to the exchange of unsecured Mexican outstandings for Mexican bonds. The principal amount of these bonds is secured at maturity by $____ face U.S. Zero Coupon Treasury Securities which mature on the same date and have a current fair value of $____. Future interest on the bonds remains a cross-border risk.
U.S.

ANNEX 3

Rule 144A (Executive Summary)

SECURITIES AND EXCHANGE COMMISSION

SUMMARY: The Commission is adopting Rule 144A, which provides a safe harbor exemption from the registration requirements of the Securities Act of 1933 for resales of restricted securities to "qualified institutional buyers" as defined in the Rule. The Commission additionally is soliciting further public comment on the definition of qualified institutional buyer as it applies to banks and savings and loan institutions under the Rule as adopted today.

The Commission also is adopting amendments to Rules 144 and 145 under the Securities Act, which redefine the required holding period for restricted securities, whether acquired pursuant to Rule 144A or otherwise.

DATES: Effective Date: April 30, 1990.

Comment Date: Comment letters on the definition of qualified institutional buyer, as it applies to banks and savings and loan institutions should be received on or before June 14, 1990.

ADDRESSES: Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street NW, Washington, DC 20549. Comments should refer to File No S7-23-88. All comments received will be available for public inspection and copying in the Commission's Public Reference Room at the same address.

FOR FURTHER INFORMATION CONTACT: Brent H. Taylor (202) 272-3246, or Michael Hyatte at (202) 272-2573, Division of Corporation Finance, Securities and Exchange Commission, 450 Fifth Street NW, Washington, DC 20549.

Executive Summary

On October 25, 1988, the Commission proposed Rule 144A (the "Rule") to provide a non-exclusive safe harbor exemption from the registration requirements of the Securities Act of 1933 (the "Securities Act")27 for specified resales of restricted securities to institutional investors.23 As originally proposed, the Rule would have provided a safe harbor for three tiers of transactions. The first tier would have exempted only resales of restricted securities to "qualified institutional buyers," defined in the initial proposal as those with assets in excess of $100 million, while the other two tiers would have provided an exemption for resales to a broader group of institutional investors. A number of commentators urged the Commission to proceed cautiously by adopting the Rule in stages. Most of the commenters suggesting a staged phase-in of the Rule favored proceeding initially with a rule that was available only to large institutional buyers. Several

27 15 U.S.C. 77a et seq.

23 Securities Act Release No. 8806 (October 25, 1988) (53 FR 44016). Eighty-nine comment letters were received. These letters and a summary of such letters are available for public inspection and copying at the Commission's Public Reference Room in Washington, DC (File No. S7-23-88).
commenters suggested that a definition of "qualified institutional buyer" linked to securities investments would provide a better test of an institution's investment sophistication than the proposed total assets test.

On July 11, 1989, the Commission reproposed a revised Rule 144A that would have established a single class of exempt transactions based on the "qualified institutional buyer" tier of the original proposal. Specifically, the revised proposal would have defined "qualified institutional buyer" to be an institution, acting for its own account, that had assets invested in securities purchased for a total of more than $100 million. The Commission noted that a definition focused on assets invested in securities should target, with more precision than the asset test originally proposed, sophisticated institutions with experience in investing in securities.

The Commission today is adopting Rule 144A. New Rule 144A provides a non-exclusive safe harbor exemption from the registration requirements of the Securities Act for resales to eligible institutions of any restricted securities that, when issued, were not of the same class as securities listed on a U.S. securities exchange or quoted in the National Association of Securities Dealers Automated Quotation system ("NASDAQ"). With the exception of registered broker-dealers, a qualified institutional buyer must in the aggregate own and invest on a discretionary basis at least $100 million in securities of issuers that are not affiliated with that qualified institutional buyer.

The Rule as adopted provides for an eligibility threshold of $10 million in securities for broker-dealers that are registered under the Securities Exchange Act of 1934 (the "Exchange Act"), irrespective of whether they are buying for purposes of intermediation or investment. In addition, to facilitate intermediation in this market, the Rule provides that a registered broker-dealer may purchase as riskless principal, as defined in the Rule, for an institution that is itself eligible to purchase under the Rule, or act as agent on a non-discretionary basis in a sale to such an institution.

In addition to meeting the $100 million in securities requirement, banks and savings and loan associations must have a net worth of at least $25 million to be qualified institutional buyers. Because of the unique status of such financial institutions as federally-insured depository institutions, the Commission is of the opinion that such an eligibility test is warranted. To avoid placing U.S. banks at a competitive disadvantage, the net worth test applies to both foreign and domestic banks. The Commission is soliciting further comment on the appropriateness of the net worth test for banks and savings and loan institutions, as well as on the appropriateness of the $25 million level.

Registered broker-dealer affiliates of banks and savings and loan associations which are subject to direct Commission oversight, would however, be able to purchase under the Rule on the same terms as other registered broker-dealers. Such registered broker-dealer affiliates would not be required to meet the net worth test.

Where the issuer of the securities to be resold is neither a reporting company under the Exchange Act, nor exempt from reporting pursuant to Rule 12g3-2(b) under the Exchange Act, nor a foreign government eligible to use Schedule B under the Securities Act availability of the Rule is conditioned on the holder of the security, and a prospective purchaser from the holder having the right to obtain from the issuer specified limited information about the issuer, and on

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24 Securities Act Release No. 6839 (July 11, 1989) (54 FR 30076). Fifty-four comment letters were received. These letters and a summary of such letters are available for public inspection and copying at the Commission's Public Reference Room in Washington, DC (File No. S7-23-88).
Although the Rule imposes no resale restrictions, a seller or any person acting on its behalf must take reasonable steps to ensure that the buyer is aware that the seller may rely on the exemption from the Securities Act's registration requirements afforded by Rule 144A.

The Commission also is adopting amendments to Rules 144 and 145 under the Securities Act. Rule 144 permits the public resale of restricted securities when certain conditions, including a minimum holding period, are met. Under the amendments, the time that must elapse before public resale of restricted securities (whether acquired in reliance on Rule 144A or otherwise) is being redefined to commence when the securities are sold by the issuer or its affiliate. In contrast to the reproposal, the amendments apply to the securities of foreign as well as domestic issuers. Because Rule 145 holding periods are determined by reference to Rule 144A. Rule 145 is being amended to reflect the changes to Rule 144.
SUMMARY: The Office of the Comptroller of the Currency (OCC) has adopted an amendment to its regulation concerning national bank lending limits with respect to the treatment of loans to a foreign government, its agencies, and instrumentalities. The amendment establishes a non-combination rule when the central government or another central facility becomes the obligor for such loans, as a result of debt restructuring. Under the amendment, the loans will continue to be included under the lending limit for the original obligor on each loan and will not be attributed to the named central obligor in the restructuring. The amendment also imposes, in such cases, an overall limitation equal to fifty percent (50 percent) of a bank's unimpaired capital and surplus with respect to all loans, in the aggregate, to the foreign government, its agencies, and instrumentalities, including restructured loans. Although the amendment is effective immediately, the OCC is requesting comment both on the possible modification of this amendment and for development of a similar rule in its broader proposed revision of Part 32, published for comment on October 24, 1989.

DATES: The final rule is effective on January 10, 1990. Comments must be received on or before March 12, 1990.
INTERNAL REVENUE SERVICE ADVANCE REVENUE RULING 89-122,
ON DETERMINATION OF AMOUNT AND RECOGNITION OF GAIN OR
LOSS, ISSUED NOV. 3 1989
(TEXT)


Part I

Section 1001 - Determination of Amount and Recognition of
Gain or Loss.

26 CFR 1.1001-1: Computation of gain or loss.
(Also Sections 165, 166, 172, 451, 1274.)

REV. RUL. 89-122

Issues

(1) In the transactions described below, which are part of a foreign country's program to reduce the amount of its outstanding debt to United States commercial banks, what is the amount of gain or loss, if any, realized and recognized by the commercial banks?

(2) What is the carryback and carryover treatment of the portion of a commercial bank's net operating loss that is attributable to a loss recognized from these transactions?

Facts

X, a United States commercial bank, holds a United States dollar denominated sovereign debt (the "Obligation") of foreign country FC. The Obligation evidences a loan from X to FC in the principal amount of $1,000,000 and bears interest at a rate of 10 percent per annum, payable annually. At the time of the transactions described below, X's adjusted basis in the Obligation, under Section 1011 of the Internal Revenue Code, is $1,000,000. The Obligation is property that is not publicly traded within the meaning of Section 1273(b)(3) of the Code. X files its tax returns on a calendar year basis, uses the accrual method of accounting, and uses the specific charge-off method of accounting for bad debts. X did not make the election described in Section 585(c)(4) concerning the elective cut-off method of changing from the reserve method of accounting for bad debts.

To reduce the amount of United States dollar denominated sovereign debt owed by FC, FC has adopted a program (the "Program") under which a holder of this debt may
negotiate with FC to modify the terms of the debt. In accordance with the Program, X and FC modify the Obligation during 1989 in the manner described in either of the following situations:

**Situation 1**

FC and X agree to reduce the rate of interest on the Obligation to 6.25 percent per annum, payable annually. The principal amount of the modified Obligation remains at $1,000,000. The present value of the payments on the modified Obligation, computed using a discount rate equal to the applicable Federal rate on the date of the modification, compounded semi-annually, is less than $1,000,000. Thus, the modified Obligation does not bear adequate stated interest within the meaning of Section 1274(c)(2) of the Code. The modified Obligation is not publicly traded within the meaning of Section 1273(b)(3).

**Situation 2**

FC and X agree to reduce the principal amount of the Obligation to $650,000. The interest rate remains at 10 percent per annum, payable annually. The present value of the payments on the modified Obligation, computed using a discount rate equal to the applicable Federal rate on the date of the modification, compounded semi-annually, is greater than $650,000. Thus, the modified Obligation bears adequate stated interest within the meaning of Section 1274(c)(2) of the Code. The modified Obligation is not publicly traded within the meaning of section 1273(b)(3).

**Law and Analysis**

In Situations 1 and 2, the terms of the Obligation are modified. Under section 1001 of the Code, if property is exchanged for other property that differs materially either in kind or in extent, then gain or loss usually results from the exchange. See section 1.1001-1(a) of the Income Tax Regulations. In general, the modification of a debt instrument constitutes a deemed exchange of debt instruments under section 1001 if the modified debt instrument is materially different from the original debt instrument. If the modification constitutes a deemed exchange, then the resulting modified instrument is treated as a newly issued debt instrument for federal income tax purposes.

In Rev. Rul. 81-169, 1981-1 C.B. 429, a taxpayer owned a municipal bond bearing interest at 9 percent, maturing February 1, 1996, and subject to sinking fund payments calculated to provide for level debt service. The taxpayer exchanged that bond for a bond of equal face amount bearing interest at 8 1/2 percent, maturing February 1, 2006, and not subject to a sinking fund provision. The revenue ruling concludes that the changes in the terms of the bonds, taken together, were material. Therefore, the exchange was a taxable transaction under section 1001 of the Code.

In Rev. Rul. 87-19, 1987-1 C.B. 249, a taxpayer owned municipal bonds bearing interest at 7 percent that contained an interest adjustment clause that triggered an increase in the interest rate on the bonds in the event of a decrease in the maximum marginal federal corporation income tax rate. Prior to the date the increase would have been triggered, the bondholder waived its rights under the interest adjustment clause. Thus, the bonds continued to bear a 7 percent interest rate rather than the 8.56 percent interest rate that would have resulted under the interest adjustment clause. The ruling concludes that the waiver was a material change in the terms of the bonds, resulting in a deemed issuance of a new bond and a taxable exchange under section 1001 of the Code.
In Situation 1, the change in interest rate from 10 percent to 6.25 percent represents a material change in the terms of the Obligation. In Situation 2, the reduction in the stated principal amount of the Obligation from $1,000,000 to $650,000 represents a material change in the terms of the Obligation. Therefore, in each situation, the modification results in a deemed exchange of the original Obligation for the modified Obligation under section 1001 of the Code.

Because the modification in each situation results in a deemed exchange, X may realize and recognize a gain or loss on each exchange. See Emery v. Commissioner, 166 F.2d 27 (2d Cir. 1948), aff'd, 8 T.C. 979 (1947) (exchange of bonds of municipal corporation does not constitute a tax-free recapitalization). Under section 1001 of the Code, the gain or loss from an exchange of property is determined by reference to the amount realized by the taxpayer from the exchange and the taxpayer's adjusted basis in the property as determined under section 1001. Section 1001(b) provides that the amount realized is the sum of any money received plus the fair market value of the property (other than money) received.

Rev. Rul. 79-292, 1979-2 C.B. 287, deals with the determination of the amount realized under section 1001(b) of the Code by a taxpayer that uses the accrual method of accounting. In Rev. Rul. 79-292, the taxpayer received long-term obligations on two separate sales of property. Based on an analysis of the accrual method of accounting under section 451 and the regulations thereunder, Rev. Rul. 79-292 indicates that the unconditional right to receive money by an accrual basis taxpayer is treated as money received to full extent of the face value of the right rather than as property received. Therefore, Rev. Rul 79-292 concludes that the amount realized by the taxpayer on each sale is the sum of the face amount of the notes plus the amount of any cash received. In reaching this conclusion, Rev. Rul. 79-292 indicates that the fair market value of a note received by an accrual basis taxpayer is irrelevant in determining the amount realized from the sale or other disposition of property.

Although Rev. Rul 79-292 concludes that the amount realized by a taxpayer that uses the accrual method of accounting includes the face amount of a note, this amount does not include any amount that is, in effect, recharacterized as interest under section 1274 of the Code. In general, section 1274 determines the issue price of a debt instrument issued in consideration for the sale or exchange of nonpublicly traded property. The issue price of such a note is the portion of the face amount that is not recharacterized as interest under section 1274.

Under section 1274 of the Code, if a debt instrument has adequate stated interest, then the issue price of the debt instrument generally is the stated principal amount (i.e., face amount) of the instrument. See section 1274(a)(1). Under section 1274(c)(2), a debt instrument generally has adequate stated interest for purposes of section 1274 if the stated principal amount of the debt instrument is less than or equal to the imputed principal amount of the debt instrument, determined under section 1274. Under section 1274(b), the imputed principal amount of the debt instrument generally is the sum of the present values of all payments due under the instrument, determined by using a discount rate equal to the applicable Federal rate, compounded semi-annually.

If the interest rate is inadequate, however, then the issue price of the debt instrument generally is the imputed principal amount of the instrument. See section 1274(a)(2) of the Code. The difference between the stated principal amount of the instrument and the imputed principal amount is treated as unstated interest that is accounted for under the original issue discount provisions of the Code.

In Situations 1 and 2, the modification of the Obligation is treated as a newly issued debt instrument for federal income tax purposes. Because the modified Obligation in each
situation is issued for nonpublicly traded property (the original Obligation), section 1274 generally determines the issue price of the modified Obligation.

In Situation 1, because the modified Obligation does not have adequate stated interest, the issue price of the modified Obligation under section 1274 of the Code is the imputed principal amount. As a result, X realizes and recognizes a loss upon the deemed exchange equal to the difference between X's adjusted basis in the original Obligation and the imputed principal amount of the modified Obligation.

In Situation 2, however, the modified Obligation has adequate stated interest. As a result, X realizes and recognizes a loss upon the deemed exchange equal to the difference between X's adjusted basis in the original Obligation and the stated principal amount of the modified Obligation.

Section 172(b)(1)(A) of the Code provides that a net operating loss (NOL) for any taxable year generally may be carried back to the 3 taxable years preceding the taxable year of the loss. Section 172(b)(1)(B) provides that an NOL for any taxable year generally may be carried forward to the 15 taxable years following the taxable year of the loss. In the case of a bank (as defined in section 585(a)(2)), however, section 172(b)(1)(K) provides that the portion of the NOL for any taxable year beginning after December 31, 1986, and before January 1, 1994, that is attributable to the deduction allowed under section 166(a) (relating to bad debts) may be carried back to the 10 taxable years preceding the taxable year of the loss, but may be carried forward only to the 5 taxable years following the taxable year of the loss.

Each exchange is the result of a bilateral agreement between X and FC, pursuant to which FC's obligation is modified, rather than a unilateral determination by X that a portion of the debt has been rendered uncollectible. Therefore, in Situations 1 and 2, the loss recognized is a loss that results from the exchange of property. The amount of the loss is determined under section 1001 of the Code and is allowed as a loss deduction to X pursuant to section 165, rather than section 166. Thus, section 172(b)(1)(K) does not apply to the loss recognized by X in either Situation 1 or Situation 2. Accordingly, the loss recognized in either Situation 1 or Situation 2 that is part of X's NOL, if any, for the taxable year may be carried back to the 3 taxable years preceding the taxable year of the loss and may be carried forward to the 15 taxable years following the taxable year of the loss.

Holdings

**Situation 1**

The reduction in the interest rate of the Obligation is a material modification that results in a taxable exchange of debt instruments under section 1001 of the Code. X realizes and recognizes a loss on the exchange equal to the excess of X's adjusted basis in the original Obligation over the imputed principal amount of the modified Obligation as determined under section 1274. The portion of X's net operating loss, if any, for the taxable year that is attributable to this loss may be carried back 3 years and forward 15 years.

**Situation 2**

The reduction in stated principal amount of the Obligation is a material modification that results in a taxable exchange of debt instruments under section 1001 of the Code. X realizes and recognizes a loss on the exchange equal to the excess of X's adjusted basis in the original Obligation over the stated principal amount of the modified Obligation. The portion
of X's net operating loss, if any, for the taxable year that is attributable to this loss may be carried back 3 years and forward 15 years.

Effect on Other Revenue Rulings

Prior to the Tax Reform Act of 1984, former section 483 of the Code generally determined the principal and interest elements of a debt instrument issued upon the sale or exchange of property. In Rev. Rul. 79-292, the interest rate on the notes satisfied the test rate under former section 483 and the regulations. Therefore, no portion of the face amount of the notes was recharacterized as interest under former section 483. Rev. Rul. 79-292 is clarified by removing any implication created by that ruling that the amount realized includes unstated interest.

Drafting Information

The principal author of this revenue ruling is William E. Blanchard of the Office of the Assistant Chief Counsel (Financial Institutions & Products). For further information regarding this revenue ruling contact Mr. Blanchard on (202) 566-3142 (not a toll-free call).
U.S.

ANNEX 6

Revenue Ruling 87-124

Issue

What are the federal income tax consequences resulting from various transactions, described below, that are part of a foreign country's program to reduce the amount of its outstanding United States dollar denominated debt?

Facts

X, a United States commercial bank, holds a United States dollar denominated debt (the Obligation of the central bank (the Central Bank) of foreign country FC. The Obligation evidences a loan of $100 that X made to the Central Bank. X's adjusted basis in the Obligation as determined under Section 1011 of the Internal Revenue Code of 1986, is $100. Under the laws of FC, the Obligation cannot be held by an FC entity.

Y is a domestic corporation. FX is a corporation organized in FC and engaged in business in FC but not in the United States. Prior to the transactions described below, there was no cross-ownership among X, Y, FX, and the Central Bank. The functional currency, as defined in Section 985 of the Code, of X and Y is the United States dollar.

The local currency of FC is the LC. On July 1, 1987, the free market exchange rate was $1 = 10 LCs.

FC has a program (the Program) whereby a holder of United States dollar denominated debt of FC can negotiate with the Central Bank to deliver the FC debt to the Central Bank for LCs if the holder agrees to invest the LCs in stock of an FC corporation or otherwise use the LCs in FC in a manner approved in advance by the government of FC. The Program controls the LCs by either (i) remitting the LCs to, or crediting them to the account of, an FC corporation that issues capital stock to the holder, or (ii) otherwise channeling the LCs to their designated use in FC. In the case of a stock investment in an FC corporation, the stock cannot be sold or otherwise transferred to FC entities. The amount of LCs the Central Bank will give the holder in exchange for the debt varies according to how the LCs are used.

In accordance with a prearranged plan pursuant to the Program, the following transactions occurred on July 1, 1987:

Situation 1

Y purchased the Obligation from X for $60, which was the fair market value of similar FC debt in the secondary markets outside of FC. X, on behalf of Y, delivered the Obligation to the Central Bank, which credited an account of FX at the Central Bank with 900 LCs. FX then issued all its capital stock to Y.
Situation 2

The facts are the same as in Situation 1, except that instead of selling the Obligation to Y for $60, X delivered the Obligation to the Central Bank, which credited an account of FX at the Central Bank with 900 LCs. FX then issued all its capital stock to X.

Situation 3

The facts are the same as in Situation 2, except that instead of crediting an account of FX, the Central Bank credited an account of Z, a United States corporation that is a charitable organization described in Section 170(c)(2) of the Code, with 900 LCs. Under the terms of the Program, Z can use the 900 LCs only in FC for charitable purposes meeting the requirements of Section 170 (including those described in Rev. Rul. 63-252, 1963-2 C.B. 101, and Rev. Rul. 66-79, 1966-1 C.B. 48).

Law and Analysis

Situation 1

Under Section 1001 (a) of the Code, the amount of loss from a sale of property is the excess of the property’s adjusted basis over the amount realized by the seller. X’s sale of the Obligation to Y produces a loss of $40 ($100 - $60). Y’s adjusted basis in the Obligation is $60; see Section 1011. The remainder of the transaction will be treated for federal income tax purposes as if Y received 900 LCs from the Central Bank in exchange for the Obligation, and then contributed the 900 LCs to FX in exchange for FX stock. See Section 1271(a)(1); Lucas Earl, 281 U.S. 111 (1930).

With respect to Y, LCs are considered property; see Rev. Rul 74-7, 1974-1 C.B. 198. Thus, Y has a gain on the exchange of the Obligation for 900 LCs with the Central Bank to the extent the fair market value of the 900 LCs exceeds $60, Y’s adjusted basis in the Obligation. The fair market value of the 900 LCs is determined by taking into account all the facts and circumstances of the exchange. The limitation on Y’s use of the 900 LCs under the Program will generally reduce their fair market value below $90 (the value of 900 LCs convertible at the free market exchange rate).

Y’s basis on the 900 LCs is $60 plus the gain, if any, recognized on the exchange. The fair market value of the FX stock is presumed to equal the fair market value of the 900 LCs. Y’s basis in the FX stock received in exchange for the 900 LCs equals the fair market value of the 900 LCs.

Situation 2

The analysis is the same as in Situation 1, except that X will be treated as if it received 900 LCs from the Central Bank in exchange for the Obligation and then contributed the 900 LCs to FX in exchange for FX stock. X recognizes a loss on the exchange of the Obligation for 900 LCs equal to the

Situation 3

The analysis is the same as in Situation 2, except that X will be treated as if it received the 900 LCs from the Central Bank in exchange for the Obligation and then contributed the 900 LCs to Z. X recognizes a loss on the exchange of the Obligation for 900 LCs equal to the
excess of X’s adjusted basis in the Obligation ($100) over the fair market value of the 900 LCs. In addition, assuming X and Z satisfy the requirements of the Code relating to charitable contributions, X is entitled to a charitable contribution deduction under Section 170 of the Code equal to the fair market value of the 900 LCs at the time of the contribution; see Section 1.170A-1(c)(1) of the Income Tax Regulations.

Holdings

Under the facts described above, the federal income tax consequences to X and Y are as follows:

Situation 1

(i) X recognizes a loss of $40 on the sale of the Obligation to Y.
(ii) Y recognizes a gain on the exchange of the Obligation for the 900 LCs to the extent the fair market value of the 900 LCs exceeds $60.
(iii) Y recognizes no gain on the exchange of the 900 LCs for FX stock because its basis in the LCs equals the stock’s fair market value.

Situation 2

(i) X recognizes a loss on the exchange of the Obligation for the 900 LCs to the extent of the excess of its adjusted basis in the Obligation ($100) over the fair market value of the 900 LCs.
(ii) X recognizes no gain on the exchange of the 900 LCs for FX stock because its basis in the LCs equals the stock’s fair market value.

Situation 3

(i) X recognizes a loss on the exchange of the Obligation for the 900 LCs to the extent of the excess of its adjusted basis in the Obligation ($100) over the fair market value of the 900 LCs.
(ii) If X and Z otherwise satisfy all requirements of the Code relating to charitable contributions, X is entitled to a charitable contribution deduction equal to the fair market value of the 900 LCs at the time of the contribution.
Dear Senator Chafee:

I am writing in response to several questions you raised following the Treasury Department’s testimony last November before the Senate Finance Committee concerning the scope of Rev. Rul. 87-124. This ruling addresses a situation in which a U.S. commercial bank transferred a debt instrument of a foreign country to the central bank of the foreign country and, in accordance with a prearranged plan, the central bank credited the account of a U.S. charity with an amount of local currency. The U.S. charity could use the local currency only in the foreign country for charitable purposes. The ruling holds that, under these facts, the U.S. commercial bank is treated as receiving the local currency from the central bank in exchange for the debt obligation (resulting in a deductible loss) and then contributing the local currency to the U.S. charity (resulting in a charitable contribution deduction).

You have asked whether the holding of the ruling would be the same under three alternative fact patterns. Under this first alternative, a U.S. commercial bank would transfer to the central bank of the foreign country debt obligations not of the central bank, but of another government agency or a nongovernmental entity organized under the foreign country’s laws. Under the second alternative, the central bank would transfer to the U.S charity newly issued bonds for the debt obligations instead of local currency. Under the third alternative, the currency or bonds would be credited or issued to a charitable entity organized under the laws of the foreign country rather than to a U.S. charity.

Rev. Rule 87-124 applies the principle that, when there are two paths available to a charitable donor, the tax consequences “turn on which path he chooses, and so long as there is substance to what he does, there is no requirement that he choose the more expensive way.” Palmer v. Commissioner, 62 T.C. 684, 693 (1974); see Rev. Rul. 78-197, 1978-1 C.B. 83. The particular facts of Rev. Rul. 87-124 were intended to illustrate this principle and not to preclude application of the principle in other appropriate circumstances.

The holding of Rev. Rule 87-124 reflected a determination that the form of the transaction chosen by the parties (i.e. disposition of the debt instrument by the U.S. bank followed by a contribution of the proceeds to the charity) had as much substance as a possible recharacterization of the transaction that would have produced less favorable tax consequences (i.e. charitable contribution of the loan by the U.S. Bank followed by disposition of the loan by the charity). This analysis of the transaction does not depend upon the identity of the issuer of the debt instrument or the form of consideration received upon disposition of the debt instrument.

Thus, we do not regard an exchange of a debt obligation of an entity other than the central bank of the foreign country, as in the first alternative fact pattern, as inconsistent with the principle underlying Rev. Rule 87-124. Similarly, we do not regard the issuance of bonds rather than local currency, as in the second alternative, as inconsistent with this principle. We note that the bonds would have to differ sufficiently from the debt obligations for the transaction to constitute an exchange in which gain or loss is recognized.

As to the third alternative, the Internal Revenue Code permits a charitable deduction only if the contribution is made “to or for the use” of charities created or organized in the United States. A U.S. charity may work in cooperation with an entity without jeopardizing the charitable
deduction, provided that the U.S. entity has such control and discretion regarding contributions as to ensure that the contributions will be used to carry out the U.S. charity's charitable functions and purposes. See Rev. Rul. 63-252, 1963-2 C.B. 101; Rev. Rule 66-79, 1966-1 C.B. 48; Rev. Rul. 75-65, 1975-1 C.B. 79. There is also authority indicating that, in some circumstances, it may be possible for funds to be credited to the account of a foreign charity if use of funds in that account is limited to a specific charitable purpose and the U.S. charity had exercised discretion in selecting that charitable purpose. See Brimley v. Commissioner, 782 F.2d 1326 (5th Cir. 1986).

The tax consequences of any transaction depend on the facts and circumstances of the particular transaction. Accordingly, in this letter we can do no more than describe the general principles that would apply to the different fact patterns about which you have inquired. The Internal Revenue Service has a private letter ruling procedure whereby it provides taxpayers with advance guidance regarding the tax consequences of particular transactions. We are confident that the Service would entertain private ruling requests regarding the fact and circumstances of a particular debt/charity conversion. No rulings, however, are given on the factual issues such as the fair market value of particular property.

Please contact me if I can be of any further assistance.

Sincerely,

C. Eugene Steuerle
Deputy Assistant Secretary

(Tax Analysis)
U.S.

ANNEX 7

DEBT FOR NATURE SWAPS

Revenue Ruling 87-124 (RR 87-124) provides that if a commercial bank exchanges a U.S. dollar-denominated debt obligation of the central bank of a foreign country for local currency and the central bank credits the local currency to the account of a U.S. section 501(c)(3) organization to use for charitable purposes in the foreign country, the bank will:

(i) recognize a loss equal to the difference between its cost basis in the debt and the debt's fair market value, and

(ii) be entitled to a charitable deduction equal to the fair market value of the local currency.

This means that in an appropriately structured transaction banks should be able to get a full deduction equal to their tax basis in the loan exchanged. According to (i) above a bank is able to deduct the loss on the loan exchanged. This deduction is approximately equal to the deduction that would have been obtained if the debt were sold in the secondary market. In addition to the deduction for the loss that would have been realized on the sale of the loan, the bank is able to obtain a charitable deduction equal to the fair market value of the debt exchanged; this is the deduction in (ii) above. The net result is that by donating its claims on a developing country a bank has the possibility of receiving a deduction that would be equivalent to the deduction that the bank would receive from selling the loan in the secondary market and donating the cash raised from this sale.

There are some potential complications in the interpretation of RR 87-124 arising from (i) requirements surrounding the identity of the donee and the use of donated funds, (ii) the valuation of the debt exchanged and (iii) the application of sourcing rules to losses claimed under RR 87-124. These issues are each considered briefly below.

Use of Donated Funds

With respect to the identity of the donee and the use of donated funds, RR 87-124 specifies that local currency credited to the account of the U.S. section 501(c)(3) organization must be used within the foreign country for charitable purposes satisfying the requirements of Internal Revenue Code (IRC) section 170, including those described in RR 63-252, 1963-2 C.B. 101, and RR 66-79; 1966-1 C.B. 48. However, the ruling does not indicate whether the charitable deduction would be permitted if the foreign country required the local currency to be credited to the account of an entity organized in the foreign country to be used in funding programs of the U.S. organization.

RR 63-252, 1963-2 C.B. 101 and RR 66-79: 1966-1 C.B. 48 and a letter from the U.S. Treasury to Senator Chaffee do provide some guidance concerning the manner in which the...
Treasury and the Internal Revenue Service could be expected to interpret RR 87-124 requirements with respect to the identity of the donee and the use of the funds donated. RR 63-252 provides that if a U.S. section 501(c)(3) organization accepts contributions earmarked for the unrestricted use of a foreign entity, the contributions will not be deductible under section 170 because the foreign organization is the actual recipient of the contributions. Under section 170(c), deductions are available only for contributions "to or for the use of organizations created or organized in the United States or in any possession thereof, or under the law of the United States, any State, the District of Columbia, or any possession of the United States."

RR 63-252 raises the question of how much involvement the section 501(c)(3) organization must have in order for the donor to be eligible to receive a charitable deduction. RR 66-79 addresses this issue. This ruling provides that contributions solicited by a U.S. section 501(c)(3) organization to fund a specific project of a foreign organization are deductible under section 170 where the U.S. organization (i) has reviewed and approved the project as being in furtherance of its exempt purposes, (ii) is not committed to transfer the contributions to the foreign organization in any event, and (iii) requires a periodic accounting by the foreign organization to demonstrate that the contributions are used for approved purposes. The ruling states that the test is whether the U.S. organization "has full control of the donated funds, and discretion as to their use, so as to insure that they will be used to carry out its functions and purposes." RR 75-65, 1975-1 C.B. 79 permitted a deduction for contributions to a U.S. conservation organization for use in foreign countries where the U.S. organization "maintained control and responsibility over the use of any funds granted a foreign organization by first making a field investigation of the purpose to which the funds [would] be put, by then entering into a written agreement with the recipient organization, and lastly by making continuous field investigations to see that the money [was] expended in accordance with the agreement."

The letter from the U.S. Treasury to Senator Chafee elaborates further on these issues. It states that there is "authority indicating that, in some circumstances, it may be possible for funds to be credited to the account of a foreign charity if use of funds in that account is limited to a specific purpose and the U.S. charity had exercised discretion in selecting that charitable purpose."

In short, it is possible to structure debt-for-nature and debt-for-development swaps in such a way that the donor can receive a charitable deduction but some care is obviously necessary to insure that the requirements with respect to the identity of the donee and the use of funds are met.

Valuation of the Debt Exchanged

Treasury Regulation section 1.170A-1 (c)(2) provides that the "fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having a reasonable knowledge of relevant facts." However, there is some possible debate about whether the relevant value should be determined with reference to the "free market exchange rate" of the local currency or with reference to the value of the debt exchanged for the currency. As a general rule, if the value of the property received is unascertainable, its value is considered to be the same as the value of the property for which it was exchanged (in this case the debt).

Sourcing of Losses

Treasury Notice 89-56 requires banks to allocate losses on the sale, exchange, or charge-off of most loans between domestic and foreign sources on the basis of the ratio in the loan portfolio between loans generating domestic source income and loans generating foreign
source income. This allocation is required regardless of the identity of the borrower as foreign or domestic. It is unclear whether the portion of the deduction claimed under RR 87-124 that is attributable to the charitable deduction should be sourced as described in Treasury Notice 89-56. This point may be of marginal significance for most actors.
U.S.

ANNEX 8

Regulatory Guidelines on Credit Limits

Lending limits have occasionally been cited by some banks as obstacles to further lending to countries in which banks have large exposures. In practice, however, lending limits do not appear to have been important obstacles to either restructurings or new money packages.

While Federal limitations on loans\(^2\), securities purchases\(^2\), (those applicable only to National banks), deposits placed with other financial institutions\(^2\), and acceptances executed on behalf of clients or purchased from other banks\(^2\)(applicable to National banks and Federal Reserve member banks) tend to be more stringently applied than those pertaining to state banks, the fact that each such limit is separate and distinct from the others provides some options with respect to the structures of individual debt reschedulings and new money packages.

For example, the Brazilian Phase I and Phase II restructurings, which provided by far the most severe test of the potential restraints of lending limits to date, differed significantly from those arranged previously in that the obligations of all public sector enterprises were consolidated into a single obligation of the Federative Republic. Additionally, the special trade and interbank deposit facility agreements provided for such obligations along with all other private sector obligations to be repaid in local currency to the central bank at their scheduled maturities, with the foreign currency payments rescheduled for a significantly longer period in the name of the central bank and the Republic. Provision was made for some of the local currency deposits (held for the account of each creditor bank) to be relent to separate borrowers. However, such lending was subject to conservative constraints and, overall, the consolidation of obligations strained United States banks' ability to comply, certainly with the lending limits contained in Federal law, but also with those of many of the 50 states. While existing Federal law clearly provided for separate recognition of loans on the one hand (12 USC 84), and deposits made by Federal Reserve Member banks with non-member banks on the other (12 USC 463), many U.S. banks still might not have been able to remain in compliance with the limitations upon their participation in the restructuring had the regulators not also been able to recognize and uphold a 1919 ruling by the Board of Governors (Ruling 1054) which stated that the limitation of 12 USC 463 did not prohibit a member bank from keeping on deposit with any foreign bank a sum in excess of such limitation. It should be recognized, however, that in upholding the 1919 ruling in the case of Brazil, the Federal Reserve tried to make clear that it was under no obligation to do so in all future events.

Salient details of each of the separate lending, securities, deposit, and acceptance limitations are provided below.

Lending limits contained in Federal law are found at 12 USC 84 and apply only to National banks. Most State laws contain similar provisions but generally are less stringent with

\(^{26}\) 12 USC 84, 12 CFR 32, 12 CFR 7.1100.

\(^{27}\) 12 USC 24, 12 CFR 1, 12 CFR 7.7570.

\(^{28}\) 12 USC 463, 1919 Federal Reserve Bulletin 1054.

\(^{29}\) 12 USC 372, 12 CFR 32, 12 USC 84,c,2.
respect to practices, discussed below, governing the combining of loans to different borrowers involved in a "common enterprise", or when more than one borrower receives benefit of the loan proceeds.

Generally, 12 USC 84 limits unsecured lending to any person to 15 percent of a bank's unimpaired capital and surplus. An additional 10 percent of capital and surplus may be lent if fully secured at all times by readily marketable collateral (securities, bullion and currencies which are fully convertible to U.S. dollars) having a market value, as determined by reliable and continuously available price quotations, at least equal to the amount of funds outstanding.

Pertinent exceptions not subject to any limitation based on capital and surplus include:

(1) Loans or extensions of credit arising from the discount of commercial business paper evidencing an obligation to the person negotiating it with recourse;

(2) The purchase of bankers acceptances of the kind described in section 13 of the Federal Reserve Act (i.e. eligible for discount) and issued by other banks;

(3) Loans or extensions of credit secured by (obligations) fully guaranteed as to principal and interest by the United States;

(4) Loans or extensions of credit secured by unconditional (obligations) of any department, agency, board, bureau, commission or any corporation wholly-owned directly or indirectly by the United States; and

(5) Loans secured by segregated deposit accounts.

There are other exceptions to the lending limitations, only one of which would appear to be relevant here. That is, loans or extensions of credit secured by bills of lading, warehouse receipts, or similar documents transferring or securing title to readily marketable staples shall be subject to a limitation of 35 percent of capital and surplus in addition to the general limitations (15 percent unsecured and 10 percent secured mentioned above) if the market value of the staples securing each additional loan at all times exceeds 115 percent of the amount of such loan.

Regulations implementing these statutory limitations contain detailed definitions and explanations of how the above exceptions are applied in practice. They also set forth rules for when loans to different borrowers are to be combined for purposes of determining compliance with lending limits. Such combinations are common with respect to loans to a partnership and its partners, and a corporation and its subsidiaries (United States or otherwise) when:

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30 "Person" means individual; sole proprietorship partnership; joint venture; association; trust; estate; business trust; corporation; not-for-profit corporation; sovereign government or agency instrumentally or political subdivision thereof; or any similar entity or organization.

31 "Unimpaired surplus" shall consist of:
(1) Fifty percent of Reserve for possible loan losses;
(2) Subordinate notes and debentures;
(3) Surplus;
(4) Undivided profits; and
(5) Reserve for contingencies and other capital reserves (excluding accrued dividends on preferred stocks).
(1) The proceeds of the loan are used for the direct benefit of another (borrowing) person or persons; and

(2) A “common enterprise” is deemed to exist between the persons (more straightforwardly, when the bank is looking to one source of repayment for 2 or more loans).

Following a similar line of thinking, loans to a foreign government (includes ministries, departments, and the central bank), its agencies and instrumentalities (public enterprises) will be combined only if they fail to meet either of the following tests at the time such loan is made:

(1) The borrower has resources or revenue of its own sufficient over time to service its debt obligations (“means” test); and

(2) The purpose of the loan or extension of credit is consistent with the purposes of the borrower's general business (“purpose” test)

Aggregation of loans to a government and its instrumentalities has not been frequent. However, it is known to have occurred in instances where either the public company was clearly dependent upon the central government for annual revenues in excess of those generated from its own operations (i.e. for over 50 percent of its operating funds, or when the borrowing enterprise did not receive access to, or benefit of, the loan proceeds (either in local or foreign currency). In the latter case, therefore, the purpose of the loan was deemed to have been made primarily for the benefit of the government (i.e. its FX Reserve balance) and not of the borrowing enterprise.

Finally, there are two additional factors that are pertinent to the discussion of lending limits:

(1) The liability of a guarantor who does not receive benefits of the proceeds is not a loan to such (guarantor) for purposes of the lending limit. i.e., a bank’s loans to borrowers, one of which is guaranteed by the other borrower, are not combined simply on the basis of a guarantee (12 CFR 32.101).

(2) The sale of federal funds by a U.S. bank to, for example, a U.S. office of a foreign depository institution is not subject to the lending limit if the sale is for one business day, or subject to a continuing contract for rollover, with no maturity. Such sales are only subject to the limits if specifically sold for more than one business day (12 CFR 32.102).

The nature of the Brazilian Phase I and Phase II restructurings described at the beginning of this section precluded any opportunity there may have been for many of Brazil’s public sector enterprises to have been recognized as separate borrowers for lending limit purposes. Nevertheless, the Brazilian example, especially in light of the volume of credit involved, provides the best example of how lending limits might have been an obstacle to restructuring and new money loans.

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32 It is important to note that while a foreign currency loan to a borrower within a country virtually always benefits the central bank’s foreign exchange reserves, such benefit does not cause failure of the "purpose" test unless the loan was made primarily for the benefit of the central bank, rather than the borrowing entity’s business purposes.
Securities Limitations

As set forth in 12 CFR 32.111, limitations on banks' purchases of "investment securities" are separate and distinct from limits applied to loans. National banks are precluded from holding in their securities portfolio any securities other than the following:

- **Type I Securities** - in which a bank may deal, underwrite, purchase and sell for its own account without limitation. These include obligations of the United States, general obligations of any State of the United States, or any political subdivision thereof.

- **Type II Securities** - in which a bank may deal, underwrite, purchase and sell for its own account, subject to a 10 percent limitation. These include specifically-named multilateral and regional development banks, U.S. Government-sponsored agency and university purposes, and states and political subdivisions.

- **Type III Securities** - in which a bank may purchase and sell for its own account subject to a 10 percent limitation (of capital and surplus) (per issuer) but may neither deal in nor underwrite.

The per issuer limitations of 10 percent of capital and surplus mentioned above are applicable only in instances where the Bank in its prudent judgment determines that there is "adequate evidence" that the obligor will be able to perform. However, when Type II or III securities are purchased based predominantly upon "reliable estimates" a 5 percent of capital and surplus limitation is applied to all such issues (not issuers) in the aggregate. When questions arise as to the applicability of the 10 percent per issuer limit arise, bankers commonly seek an OCC ruling on the eligibility for purchase, and such rulings tend to be very conservatively made. The Aztec bonds were classified as Type III investment securities which banks could only hold in their securities portfolio in an amount up to 5% of their capital. The Brazilian exit bond, on the other hand, were judged by the OCC not to satisfy the quality requirements for Type III investment securities. The OCC stated in a 1989 letter that "the uncertainty of principal repayment, their concessionary interest rate and ten year grace period for repayment of principal and interest are attributes that keep those issues from attaining 'investment securities' status and therefore these securities are not eligible for bank investment". The OCC rules that the Brazilian exit bonds were, therefore, subject to the lending limitations of 12 U.S.C. 84.

These limitations, however, do not preclude a bank from holding additional securities as described in the section of this report dealing with the Federal Reserve's Regulation K.

Deposit Limits

Banks which are members of the Federal Reserve System are precluded from keeping on deposit with non-member banks amounts which exceed 10 percent of unimpaired capital and surplus (12 USC 463). As described early in this section, however, the regulators have relied upon a 1919 Federal Reserve Bulletin (#1054) to rule that deposits made with the Brazilian Central Bank, and in accordance with the restructuring agreements, were deposits not prohibited by 12 USC 463.

Acceptance Limitations

Any member bank may accept drafts or bills of exchange drawn upon it having not more than six months sight to run, exclusive of days of grace: (1) which grown out of transactions involving the importation or exportation of goods; or (2) which are secured at the
time of acceptance by a warehouse receipt or other such document conveying or securing title covering readily marketable staples (12 USC 372). Issuance of the first type is subject to a limitation per person, partnership, corporation or other entity on whose behalf the bank is obligated, of 10 percent of the bank's capital and surplus. The second type is not limited with respect to individual customers, but both types are limited in aggregate to 150 percent of the bank's capital and surplus, or 200 percent with specific approval from the Federal Reserve.

Purchases, however, of "bankers acceptances of other banks" which meet the above criteria (and these may be eligible for discount by the Federal Reserve) are not subject to any limit.
The Financial Accounting Standards Board Statement No.15 (FASB 15) of June 1977 establishes accounting principles for “troubled debt restructurings.” For accounting purposes, there are two types of restructurings: (i) transactions which involve an exchange of assets (or equity interest) from a debtor to a creditor in full settlement of a debt; and (ii) restructurings which involve only a modification of the terms of the existing claim. As discussed below, these two types of transactions are accounted for in different ways.

FASB 15 defines a “troubled debt restructuring” as a restructuring of debt in which the “creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider.” The concession may take the form of (a) interest rate reduction; (b) extension of maturity dates; (c) reduction of principal; and (d) exchange of debt for equity, real estate, receivables from third parties or other assets. Debt/equity swaps, exchange offers, reduced rate loans or reductions in principal could all qualify as troubled debt restructurings.

However, if the creditor receives in the troubled debt restructuring receivables from a third party, real estate, other assets or an equity interest in the debtor, then the consideration received must be accounted for at its fair value. If the recorded balance of the debt is greater than the fair value of the assets or investment received by the creditor, then the amount by which it is greater is recorded as a loss. FASB 15 defines “fair value” as the amount the creditor could expect to receive in a current sale between a willing buyer and a willing seller. If an active market exists, fair value is market value. If there is no adequate market, then fair value is estimated based on expected cash flows discounted for risk.

If the new agreement only modifies the terms of the existing agreement, then the “modified” asset does not have to be accounted for at its fair or market value. FASB 15 specifies that so long as the future cash receipts specified by the new terms are at least as great as the recorded investment, the recorded investment may be left unchanged and interest income should be recorded using an effective interest rate that equates the present value of future cash receipts with the recorded investment. If the future cash receipts specified by the new terms are less than the recorded investment, then the investment is written down to the nominal value of specified future cash receipts. Interest income is no longer recognized and all payments go towards recovering the recorded investment.

If the troubled debt restructuring involves a combination of a modification of the terms of the existing agreement and an exchange of new assets, the recorded investment is reduced by the fair value of the new asset. If the undiscounted future cash receipts due according to the terms of the modified agreement are equal to or exceed the remaining investment, no loss is recognized and the effective interest rate at which income is recognized is the discount rate which equates the present value of the future cash receipts specified by the new terms with the recorded investment reduced by the fair value of assets in exchange for partial satisfaction of the creditor's claim. This might happen, for example, should a creditor agree to receive equity in a public enterprise in partial satisfaction of the claim and to reduce the interest rate on the remainder of the claim. Depending on the details of the transaction, it might be possible to settle claims in this way without the commercial bank being forced to recognize any immediate loss.
One difficulty in determining how FASB 15 should be applied to a particular situation is determining whether the transaction should be characterized as a modification of the terms of the existing asset as an exchange of old loans for a new asset. For example, if the new terms include insuring or collateralizing portions of a loan, does this qualify as a new asset? Does it matter if the assets received are marketable? Does it matter if interest rates are fixed or floating? How large a concession must be given for FASB 15 to apply? Clarifications in this area are likely to be important in determining the way that transactions are to be structured.

During the era of concerted new money packages United States commercial banks argued that major restructurings of sovereign debt were not troubled debt restructurings. United States banks have argued that the interest rates charged for new money packages were market-based rates and would have been granted in the absence of the present financial difficulties of these countries. In support of this commercial banks' stance, the SEC issued specific disclosure guidelines for Brazil (1983) Mexico (1984) and Argentina (1984) stating that the reschedulings did not qualify as troubled debt restructurings. The spreads were still profitable and have not changed sufficiently to be characterized as a major concession of the type usually present in a troubled debt restructuring. In contrast, the Brazilian exit bonds, which carried a sub-market rate of interest, were considered eligible for FASB 15 treatment. The issuance of the July 14, 1989 letter from the SEC to David Mulford in the U.S. Treasury clarified to a large extent the application of FASB 15 to voluntary debt reduction. Although, this letter addresses directly only the details of the Mexican financing package, its principles could be extended to other restructurings.

Classification of a transaction as a troubled debt restructuring carries with it very strict reporting requirements (SEC Industry Guide 3). The use of FASB 15 entails the following disclosures about the troubled debt restructurings: (i) the aggregate investment in modified loans; (ii) the amount of interest income recognized on such loans; (iii) the amount of interest income which would have been recognized under the original terms; and (iv) commitments of additional funds to restructured debtors. While banks have argued that such disclosure requirements are a disincentive to use FASB 15, these requirements differ little from those which apply to most of their claims on the highly indebted countries in any case.
Japan

The Ministry of Finance (MOF) is the most important official body in Japan that establishes and implements rules and regulations determining the timing of the recognition of tax and regulatory losses on sovereign loans of Japanese banks. This is because the power to supervise, regulate and tax banks are concentrated in the MOF. In addition, the MOF is the dominant force in accounting matters. The MOF has very broad powers to issue instructions ("Gyosei Shido") to the banking industry. But because the instructions are frequently issued in less formal and open ways than in some other national supervisory systems it is sometimes difficult to be precise about the state of MOF policy. We have tried to indicate where specific difficulties of this kind exist.

Since September 1989, MOF tax and regulatory policy towards the treatment of sovereign debt has continued to evolve. The MOF has continued to restrict the ability of Japanese banks to record tax losses outside of the context of debt reduction operations. Japanese banks that wish to participate in secondary market operations must seek the approval of the MOF. Reportedly, the MOF has become more flexible in its treatment of such transactions. But the volume remains small so that the main avenue for Japanese banks to realize tax and regulatory losses on their sovereign loans is to participate in voluntary debt reduction operations.

Among the most important specific developments are:

(i) The MOF issued guidance with respect to the tax and regulatory treatment of the instruments issued in the context of the Brady package. In principle both of the instruments should be marked to their market value, which is defined as their first traded price on the Luxembourg exchange.

(ii) After initially increasing the cap on provisioning to 40%, the MOF abolished the cap on provisioning for loan losses on certain sovereign debts on and after the fiscal year ending March 31, 1991 and currently the ratio can be decided by each bank. Although 40% remains an "indication" for the banking industry, it is not a statutory "cap".

The tax treatment of provisions remains unchanged. This treatment and the detailed treatment of particular debt restructuring instruments are described below.

Tax and Regulatory Issues

The recent developments concerning the tax and regulatory treatment of sovereign debt in Japan are:

1. Increase in allowable provisions

Reserves against sovereign risk are normally established as Reserves for Specified-Overseas Receivables (SOR). This reserve was introduced by regulation on March 31, 1983 and was designed for potential losses due to transfer risks arising from loans to foreign borrowers. The SOR is included in capital and a portion is treated as tax deductible as described below. Contrary to the Special Reserve (described below), which is established against a particular loan, the SOR is applied to all commercial bank loans to a foreign country in which the collectibility of the assets is recognized as doubtful as determined by the existence of any of the following conditions:
The repayment of principal or payment of interest on the loans to a government, a central bank, public sector entities and government-owned corporations of the relevant countries is delayed more than one month at the end of the accounting period;

Agreements for rescheduling (including refinancing and relending) were made within five years before the lending bank's balance sheet date;

A request for rescheduling has been made during the last month preceding the end of the accounting period.

While the MOF has not disclosed a list of countries against which the SOR is allowed, the authors have estimated, based on the criteria listed above, that the SOR is allowed against approximately 60 debtor countries. The tax deductibility of the SOR is described below.

As of March 1990, Japanese banks were allowed to increase their provisions against sovereign risk (i.e. the SOR) to 25% of their exposure to a specified group of countries that have shown debt servicing difficulties. In May 1990, the Ministry of Finance (MOF) increased the allowable provisions to 100% of exposure to the list of troubled debtors. MOF planned to slowly raise the allowable provision against sovereign risk to 100% of exposure to the list of countries that have rescheduled or otherwise evidenced debt servicing difficulties. This policy was designed to discourage competitive provisioning among Japanese banks. However, as indicated above, the MOF has abolished the cap on provisioning for loan losses on certain sovereign debts on and after the fiscal year ending March 31, 1991 and currently the ratio can be decided by each bank.

The reserve against sovereign risk remains included in regulatory capital, except for the 1% of their exposure to the specified countries which Japanese banks may deduct from taxes. As the Basle guidelines limiting the inclusion of loan loss reserves in capital come into full effect, a number of Japanese banks may be forced to exclude a portion of their reserves against sovereign risk from regulatory capital.

It is important to keep in mind that the 100% loan loss reserve against sovereign risk is a maximum; banks could establish a lower reserve. 40% remains an "indication" for banks, but it does not represent a statutory cap. But, for competitive reasons and in order to signal their strength to markets, Japanese bankers feel strong pressure to match the provisioning levels of their competitors. Consequently, Japanese banks have continued to provision the maximum allowed against sovereign debts.

2. MOF guidance for 1990 Mexican Financing Package

In October 1989, the Banking Bureau and the International Finance Bureau of MOF issued administrative guidance with respect to the tax and accounting treatment of the Mexican bonds (see Annex 1). According to this guidance the bonds should be recorded at their acquisition price for both tax and accounting purposes. The acquisition price of these bonds "shall be the first traded price" on the Luxembourg exchange, where the bond were registered. It is technically more accurate to say that the bonds should be accounted for at the lower of cost or market. The cost of the bond would be equal to the face value of the bond and the market price is defined as the acquisition price or the first traded price on the Luxembourg exchange. However, in practice it is clear that the market price of the bonds will be lower than their cost or face value.

In addition to the recognition of the loss on the exchange, the bonds received must be revalued annually in accordance with the bank's normal accounting method for listed
securities. Thus if the bank carries the bonds in its trading portfolio and uses the lower of cost or market method for valuing listed securities, any subsequent drop in value would be recognized as an expense for book and, if elected, tax purposes.

It should be noted that the above accounting treatment applies only to listed securities. If the securities are not listed, then the bonds should be accounted for at their historical cost i.e. the face value of the new bond received.

MOF has not indicated whether the accounting treatment that was applied in the case of the Mexican bonds should be applied to other bonds issued in the context of other debt reduction operations. It seems likely that instruments issued in other operations which involved debt reduction and instruments issued in the form of credit enhanced bonds would be treated in the same manner. However this is an area where we still have some uncertainty about the MOF policy. Clear resolution of this question awaits further MOF guidance in future debt reduction operations. To date, MOF has issued no publicly available guidance with respect to the accounting and tax treatment of bonds issued in the context of the Costa Rican and Venezuelan debt reduction operations.

3. **Rules on secondary market transactions**

The MOF continues to require approval of transactions involving the sale of sovereign loans. Because the transactions are approved on an ad hoc basis it is difficult to identify the details of the MOF policy towards secondary market transactions. But MOF has reportedly been more flexible in approving transactions and in allowing bank participation in secondary market transactions. Japanese banks have been able to claim tax deductions upon participation in debt reduction operations and a limited number of secondary market transactions.

As discussed in our earlier report, Japanese banks may sell loans to Japanese corporations if those corporations are using loans to engage in debt/equity swaps. While Japanese banks may not participate directly in debt/equity swaps, MOF has encouraged such transactions by permitting Japanese corporations to avoid recognizing taxable income when buying debt at a discount and contributing it to the capital of its foreign subsidiary. In March 1987, MOF also permitted 28 Japanese banks to establish a Cayman Island-based joint factoring company, Japanese Bankers' Association Investment (JBA) and to sell a limited number of loans to this company. Claims on Brazil, Mexico and Argentina with a face value of approximately $1.5 billion have been sold to JBA.

MOF has consistently approved of Japanese bank participation in debt reduction operations. This approval has been accompanied by allowing Japanese banks to claim tax deductions for losses realized in these transactions.
4. **Tax Treatment of Provisions**

The tax treatment of loan loss provisions remains unchanged. MOF continues to allow Japanese banks to create three types of tax allowable provisions. These three types are:

(i) **Special Reserve (SR).** The SR is a specific reserve established for loans that have little or no likelihood of being paid. An SR up to 50% of the face value of a specific loan can be deducted from taxable income. MOF has not indicated whether this treatment has been extended to sovereign loans. The stated requirements of the application of the SR are:

   (a) a declaration of default against the borrower, or
   (b) principal and interest have not been paid in the last three years measured from the end of the last accounting period.

   To our knowledge, the first and second criteria have not been satisfied in the case of any sovereign borrower. No default has been declared against any sovereign borrower, and it is very rare that countries pay absolutely nothing for three years. Often even countries that have declared moratoriums continue to pay at very low rates. It is unclear whether MOF has issued the required certificates of loss to any Japanese banks for loans to any country.

(ii) **Specified-Overseas-Receivable (SOR) which was introduced in March 23, 1983** remains tax deductible in an amount equal to one percent of:

   (a) the incremental amount of loans to those listed countries since April 1, 1984, or

   (b) the outstanding amount of rescheduled, or refinanced, loans agreed after April 1, 1984 at the end of the accounting period.

   The amount of tax losses on sovereign loans claimed as a result of provisioning in Japan remains quite small compared with other countries.

(iii) **General Provision.** It remains possible for Japanese banks to deduct general provisions up to an amount equal to (a) 0.3% of loans outstanding at the balance sheet date; or (b) total loans (as defined by tax law) outstanding at the balance sheet date multiplied by the average loan loss ratio for the three years preceding the reporting year.

5. **Sale of Loans to Offshore Subsidiaries**

MOF has not extended the scheme of March 1987 in which 28 Japanese banks created a Cayman Island based joint factoring company to purchase loans from the banks and, thereby, allow the banks to realize tax losses on their LDC loans.

The scheme may remain a vehicle for MOF to encourage Japanese banks to participate in financing packages. It has not been reported that the factoring company approach has been employed beyond the sales of $620 million of Mexican debt in 1987 and $800 million in Brazilian and Argentinian debt in 1989.
Tax and Regulatory Treatment of Specific Instruments

Discount bonds

If the bonds are listed they should be recorded for tax, regulatory and accounting purposes at the lower of cost or market. MOF guidance issued in the context of the 1990 Mexican Financing Package suggests that in practice bonds issued in the context of sovereign debt restructurings should be recorded at their first traded price at the exchange on which they are listed.

Par bonds

As in the case of discount bonds, if the bonds are listed they should be recorded for tax, regulatory and accounting purposes at the lower of cost or market. MOF guidance issued in the context of the 1990 Mexican Financing Package suggests that in practice bonds issued in the context of sovereign debt restructurings should be recorded at their first traded price on which exchange they are listed.

Buyback

The tax, accounting and regulatory treatment of the buyback is straightforward. Permission from MOF is still required for loan sales. To date MOF has consistently given permission in the context of debt reduction operations. Assuming MOF gives permission, banks participating in a buyback would recognize a loss equal to the difference between the book value of the original loans and the fair value of the cash received.

New Money

New money loans would be treated as existing loans for provisioning purposes. As described above, new money loans may in some cases be eligible for sale to an off-shore subsidiary. This may enhance the value of the loan to Japanese banks because loans sales to the subsidiary would allow the banks to realize tax losses.

Interest Capitalization

Overdue interest is normally treated as income for tax and accounting purposes until such time that a bank receives approval from the MOF for placing the loans on nonaccrual. On the other hand, interest capitalized would normally be accrued as income for tax and accounting purposes in the absence of specific guidelines from the MOF to the contrary.

According to existing rules the receipt of notes in exchange for past due interest as in the Costa Rican transaction would constitute a taxable event. If the notes are in the form of securities and are listed on an exchange, they would be accrued as income in any amount equal to their first traded price on the exchange where they are listed. If the notes are in the form of loans or unlisted securities they would be accrued into income at their face amount.

This treatment of past due interest may present a significant disincentive for Japanese banks to participate in financing arrangements which involve resolving past due interest by issuing new debt to creditors. The MOF may need to provide further guidance on this issue. Alternatively, there may be ways of structuring packages to avoid the adverse tax consequences of the capitalization of past due interest.
According to the Japanese rules no distinction is made between agreements to capitalize past due interest and agreements to capitalize future interest payments.

**Interest vs. Principal Enhancement:**

In Japan, there is no difference between the treatment of interest and principal enhancements for reserves, disclosure or capital adequacy purposes. The exposure which must be disclosed to MOF is reduced by the current value of enhancement. The exposure against which the reserve ceiling is calculated is similarly reduced and the reduced risk weight associated with the credit risk of third parties that enhance instruments is multiplied by the current value of the enhancement regardless of the placement of the enhancement on interest or principal.
### Japan

**Matrix of Regulatory and Tax Treatment of Different Financial Instruments**

<table>
<thead>
<tr>
<th>Instrument</th>
<th>Accounting Treatment</th>
<th>Tax Treatment</th>
<th>Regulatory Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reduced Rate Loan</td>
<td>No gain or loss recognized</td>
<td>Same as accounting.</td>
<td>Same as accounting.</td>
</tr>
<tr>
<td>Par Bond</td>
<td>Approval required. But MOF has required loss down to first traded price on official exchange.</td>
<td>Same as accounting.</td>
<td>Same as accounting.</td>
</tr>
<tr>
<td>Discount Bond</td>
<td>Approval required. But MOF has required loss down to first traded price on official exchange.</td>
<td>Same as accounting.</td>
<td>Same as accounting.</td>
</tr>
<tr>
<td>Debt/Equity Conversion</td>
<td>Not done by banks.</td>
<td>Not applicable.</td>
<td>Not applicable.</td>
</tr>
<tr>
<td>Buyback</td>
<td>Will depend upon negotiations with appropriate authorities.</td>
<td>Same as accounting.</td>
<td>Same as accounting.</td>
</tr>
<tr>
<td>New Money</td>
<td>Face Value with LLR as determined by individual bank.</td>
<td>1% of exposure is tax deductible.</td>
<td>1%/ of exposure is tax deductible.</td>
</tr>
<tr>
<td>Interest Capitalization</td>
<td>Income</td>
<td>Income</td>
<td>Income</td>
</tr>
<tr>
<td>Conversion into Local Currency Loan at Current Exchange</td>
<td>Unknown</td>
<td>Unknown</td>
<td>Unknown</td>
</tr>
</tbody>
</table>
1. Regarding the tax and accounting treatment of the Mexican bond which commercial banks will get through loan/bond swaps in the Mexican new debt strategy, we have discussed it with the related bureaus and thus reached an agreement on that treatment with the Tax Bureau and the Securities Bureau as follows:

(a) The Mexican bond will be listed at the Luxembourg stock exchange. The acquisition price of that bond shall be that first traded price at the exchange. If the bond is not traded for the time being, the indication price shall be the bond price.

(b) The price difference between the book value (principal value) of the loan before being swapped for the Mexican bond and the acquisition value of the bond is recognized as a loss in terms of accounting. It is also treated the same in terms of tax treatment.

2. The above announcement was made orally to commercial banks (no date available).
France

Bank supervision and regulation in France reflect the powerful authority exerted by banking authorities on behalf of the banks' major shareholder, the French Government, as well as the attempt by the French government to improve the banks' capital structure in a context of mounting competition and of the gradual return in early 1986 of financial institutions to private ownership. Although French banks have substantial risk exposure to developing countries, they are not among the most adequately capitalized or profitable banks. As a result, tax and regulatory policies governing loan loss provisioning against sovereign loans continue to have the dual objective of strengthening the banks' ability to absorb losses on specific loans and improving their overall financial position. Although as described below, there has been some official discussion of change, French banks continue to enjoy the unique benefit of building up tax deductible loan-loss provisions while at the same time including those provisions in their regulatory capital. As a result of this situation French banks reportedly continue to be reluctant to participate in some transactions involving deep discounts, due to the need to recognize large capital losses upon participation in such transactions. This advantage, however, will be eroded by the eventual full application of the Basle guidelines to French banks; the application of these guidelines will limit the potential for including loan loss reserves in capital.

Institutional Framework

Following the promulgation of the Banking Law of January 1984, all credit institutions in France were brought within the supervisory authority of three organizations: the Banking Commission, the Committee on Bank Regulation, and the Committee on Credit Institutions. The Banking Commission, presided over by the Governor of the Banque de France, is responsible for ensuring the safety and soundness of credit institutions, and for monitoring their compliance with relevant laws and regulations. The Secretariat of the Banking Commission is a division of the Banque de France. It is through the Banque de France that the Commission verifies the accounting records and legal compliance of all French banking institutions. The Committee on Bank Regulation, directed by the Minister of Finance, issues prudential regulations and accounting ratios. The Committee on Credit Institutions is directed by the Governor of the Banque de France as president and the Director of the Treasury and is responsible for approving licenses for new banks. In addition, the Conseil National du Credit has a consultative role and it is charged with advising the Ministry of Finance on matters relating to the general functioning of the banking and financial systems as well as on monetary and credit policy.

Disclosure Guidelines

The 1984 Banking Act has tightened certain accounting and disclosure requirements. Each bank is required to send a periodic statement of its assets and liabilities to the Commission Bancaire. The commercial banks must submit interim reports at the end of every six-month period and balance sheets, profit and loss accounts at the end of every accounting year. Banks must present their financial statements on a consolidated basis.

Country risk disclosure guidelines have become significantly more stringent over the last few years reflecting an on-going process of supervisory coordination within the BIS area but also the Banque de France's effort to improve the monitoring of French banks' country risk exposure. Initially, the French banks participated in a BIS-sponsored pilot survey of the country risk exposure of international banks from 14 countries on June 1977. At that time, the Banque de France decided to set up its own centralized country risk exposure survey for the French banking system. In November 1983, the Banque de France disseminated a consolidated survey of the French banking system risk exposure on about 100 countries, accompanied by a currency and
maturity breakdown. Since then, the central bank has issued a quarterly survey of the external assets of the consolidated banking system. No specific country limits are imposed, although the reports are monitored by the Commission Bancaire to reveal trends and any exposure considered large in relation to the bank's capital base would be the subject of comment.

The Banque de France operates a Central Risks Service which collects and distributes information on banking risks and credits for the use of individual banks ("System SEMEX/Serie 10-4-1"). The banks are required to report total aggregate obligations including leasing credits to any single borrower in excess of a specified amount. The Central Risks Service, in turn, reports back to the respective banks the total position of indebtedness of each country vis-a-vis the entire banking system. The Banque de France has agreed to provide certain data on foreign lending derived from such consolidated reports to the BIS. Specific country risk exposure is not publicly disclosed by the French supervisory authorities.

Nonaccrual Loans

There is no authoritative accounting pronouncement requiring disclosure of information on past due loans or regarding the recognition of interest income on past due loans. Once a loan has been classified as "doubtful" (which is a separate account from other loans under French accounting rules), interest thereon would normally be provided for; the decision to place a loan in doubtful status is a management decision and no fixed rules apply. As discussed below, the Commission has issued a recommendation to all banks regarding the recognition of income on sovereign debt arrears. In general, income recognition would cease after such loans are three months overdue. There are a variety of disclosures in practice. Most of the banks disclose very little, if anything. Some indicate the problem in the Directors' report to shareholders without quoting any figures or accounting policies.

Since September 1989, there have been some important specific developments in the treatment of sovereign debt in France. Among the most important developments are:

(i) In response to the 1990 Mexican Financing Package, the Director of the Treasury informed banks that the normal (disadvantageous) tax treatment of bonds would be modified for the purposes of the Mexico transaction. It remains somewhat unclear whether or not this treatment will apply to other transactions.

(ii) According to press reports, the average level of French bank provisioning against sovereign risk has increased from about 38% to over 50%.33

Some of the specific tax and regulatory issues affecting French banks are discussed below. The annexes include copies of the most important letters relating to sovereign debt that have been issued by French regulatory authorities.

French banks' developing country claims are heavily concentrated with a limited number of sovereign debtors. Thus, the nine major debtor countries which have implemented, or are about to implement, debt restructuring workouts amount to about 25% of the French banking system's overall country risk exposure at end-1989.

33 Note that the French banking authorities do not make public information on bank provisioning levels. The numbers given here are based on our own estimates. They do not reflect the views of the World Bank nor have they been confirmed by French banking authorities.
Exposure of the French Banking System to Major Troubled Debtor Countries  
(as of January 1, 1990, in US$ millions)

<table>
<thead>
<tr>
<th>Country</th>
<th>Total</th>
<th>o/w guaranteed credits</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mexico</td>
<td>4,984</td>
<td>676</td>
</tr>
<tr>
<td>Philippines</td>
<td>1,140</td>
<td>38</td>
</tr>
<tr>
<td>Costa Rica</td>
<td>35</td>
<td>9</td>
</tr>
<tr>
<td>Venezuela</td>
<td>2,805</td>
<td>879</td>
</tr>
<tr>
<td>Argentina</td>
<td>2,260</td>
<td>188</td>
</tr>
<tr>
<td>Brazil</td>
<td>8,447</td>
<td>2,570</td>
</tr>
<tr>
<td>Poland</td>
<td>1,380</td>
<td>58</td>
</tr>
<tr>
<td>Morocco</td>
<td>2,078</td>
<td>1,010</td>
</tr>
<tr>
<td>Cote d'Ivoire</td>
<td>2,041</td>
<td>235</td>
</tr>
</tbody>
</table>

General Tax and Accounting Issues

1. Tax and regulatory treatment of reserves

French banks are allowed to make two categories of loan loss provisions against medium- and long-term credits: (i) specific provisions and (ii) general provisions. Specific provisions are established against individual assets whose recovery is doubtful. Tax deductibility is granted under the condition that loss is probable. General provisions are established against other assets. These general loan-loss provisions are tax deductible and amount to a non-allocated financial reserve. The annual incremental provision cannot exceed 5% of the pre-tax income of the banking entity. In addition, in the bank's balance sheet, provisions cannot exceed 0.5% of total medium and long-term assets.

The treatment of sovereign debt in France continues to allow banks to both deduct provisions from taxable income and to include reserves as part of regulatory capital. As a result of the favorable treatment of provisions, French banks have established high and steadily increasing reserve levels. At the end of 1987 the average reserve level of French banks with respect to their exposure to 55 developing country debtors was about 38%. At year end 1988, this average had increased to 44%. Year end figures for 1989 suggest that French bank provision levels may have increased to over 50%. (As noted above these figures are only estimates). The current level of loan loss reserves in the three largest French banks (i.e. B.N.P., Credit Lyonnais, and Societe Generale) have reached the 58% level.

These provisions are deductible up to the average level of provisions on a country basis, as established by the French banking community. At the end of each fiscal year, French banking authorities survey reserve practices of French banks and calculate the average reserve levels of French banks with respect to individual countries. Banks are informed of these average levels. Since 1987, the Commission Bancaire has informed banks of average industry reserve levels. Banks were also informed in 1987 that they were required to make provisions to set their reserve levels equal to the industry average calculated at the end of the previous fiscal year. Due to the mandatory nature of these provisions, the Treasury has treated the provisions as tax deductible. Deductions in excess of this level must be negotiated individually with the French
treasury. As indicated above, the average level of provisions maintained by French banks, as calculated by French banking authorities, is not made public.

There has been some discussion in France of altering the regulatory treatment of reserves. As mentioned above these reserves are currently included in regulatory capital. However, the Basle guidelines which take full effect at the end of 1992 and the transition guidelines which took effect at the end of 1990, limit the inclusion of general loan loss reserves in regulatory capital to about 40% of Tier II capital or 1.25% of risk weighted assets. At the time the Basle guidelines were agreed upon in 1989, French authorities negotiated an exception to the 40% limitation on the inclusion of general reserves in Tier II capital. According to this exception banks, at the discretion of national regulatory authorities, may "temporarily and exceptionally" include general reserves in capital up to an amount equal to about 55% of Tier II capital or 2.25% of risk weighted assets. French banking authorities have discussed removing this exception, thereby forcing many French banks to recognize losses of regulatory capital when they provision. French banking authorities have yet to provide a definitive resolution of this issue. To the extent that French banks are forced to recognize capital losses as a result of provisioning it may make them more prepared to participate in debt reduction operations. French banks have apparently expressed some reluctance to participate in debt reduction schemes in countries where debt is trading at a very deep discount. This reluctance may be related to the heavy capital cost involved in the transaction.

2. Tax Treatment of Bonds

The tax treatment of bonds in France has been perceived to be an obstacle to structuring debt reduction transactions in some countries. In response to the 1990 Mexican Financing Package, the Director of the Treasury informed banks that the normal tax treatment of bonds would be modified for the purposes of that transaction. The Treasury stated in its letter of October 10, 1989 that (i) banks would be allowed to maintain country-risk provisions on their claims following the acceptance of both the discount and par bonds and (ii) using a straightline method, banks would be required to recapture their provisions over the life of the instrument. This treatment modified the normal treatment of bonds which would have required provisions to be reversed immediately due to the fact that the principal was fully collateralized. If banks choose to establish additional provisions to reflect a market value of the bond below its face value, these provisions would be deducted at the capital loss rate of 19% rather than that applied to ordinary losses of 42% (34% as of January 1991 for nondistributed earnings). In the Treasury's letter of August 8, 1990 the same treatment was applied to Venezuela and other LDC debt.

Tax and Regulatory Treatment of Specific Instruments

Discount bonds

For accounting and regulatory purposes the acceptance of a discounted bond in exchange for existing debt is considered to be a disposition of the existing asset and subject to the treatment reserved for asset sales (i.e. a “cession parfaite”). Upon acceptance of the bond a book loss must be recognized equal to the difference between face value of the original loan and the issue price of the new bond (i.e. face value adjusted for premiums or discounts). The loss is charged to provisions. If the loss exceeds the specific provisions allocated to that loan a charge is taken to income.

With respect to country risk provisions, the Banque de France stipulated that the provisions are to be recaptured into the income statement only to the extent that overall provisions following the exchange offer are above the average level of the banking community. The credit enhanced bonds do not require new provisions so long as there is no further deterioration of the
Mexican risk. However, it should be kept in mind that some French banks seem to want to provision due to the somewhat attractive tax and regulatory treatments of provisions.

Overall, the tax treatment of bonds in France has been perceived as an obstacle to some debt reduction transactions, primarily due to the fact that provisions on bonds are deductible at the long-term tax rate of 19%.

**Par bonds**

For accounting and regulatory purposes the acceptance of a par bond does not normally lead to the recognition of a loss for book purposes.

**Buybacks**

For regulatory and accounting purposes, the acceptance of cash in exchange for an existing asset results in the immediate recognition of loss equal to the difference between the face value of the existing asset and the value of the cash received. This loss must be charged to provisions. If the loss exceeds the provisions allocated to the loan exchanged, a charge to income would be taken.

For tax purposes, a buyback would result in the recognition of a tax loss only to the extent that the difference between face value of the original loan and the value of the cash received exceeded the tax allowable provisions that have been allocated to the loan exchanged.

Reportedly, French banks have been reluctant to consider some proposals for buybacks in some countries with very steep discounts on their debt due to the large capital loss that must be recognized. Countries considering such options may need to offer French banks options in addition to the buyback to accommodate the unique tax and regulatory concerns of French banks.

**New Money**

In response to the new money option in the 1990 Mexican Financing Package, the Banque de France issued two letters. The first letter issued on October 30, 1989, stated that incremental exposure does not require additional provisions as long as the overall provision level is consistent with the average level of the French banking community and the economic situation of the debtor country did not deteriorate further. Apparently the ruling caused some confusion among French commercial bankers. Some bankers interpreted the ruling to prevent the establishment of further provisions. In response to this confusion, the Banque de France issued a second letter on November 6, 1989 which stated that banks may increase their provisions on new money if they believe such incremental provisions are necessary. Banks would be allowed to increase their reserves to levels that exceeded the average for the French banking community. Many banks wanted to increase their reserve level due to the attractive tax treatment of provisions.

**Interest Capitalization**

For regulatory and accounting purposes the treatment of interest capitalization is unclear. French banking authorities seem to make a distinction between agreements to capitalize past due interest and agreements to capitalize future interest payments. With respect to past due interest, banking authorities would probably require banks to establish large provisions against the principal of capitalized interest. As a result only limited income recognition would be allowed.
In the case of agreement to capitalize future interest payments, authorities would allow banks to recognize income so long as banks judge the borrower to be willing and able to pay and the borrower is not in default on other loans.

For tax purposes the treatment of interest capitalization should follow the accounting and regulatory treatment. Banks would not be required to recognize income for tax purposes which had been disallowed for accounting and regulatory purposes. The only exception to this general rule would be the case where banks establish provisions to capitalize interest in excess of those required by Commission Bancaire.

*Interest vs. Principal Enhancement*

In the French accounting and regulatory system, provisions are considered to be provisions against the principal of an asset. If the asset is secured by guarantees or collateral, then from a technical point of view the asset should no longer be reserved against. This may be an attractive feature of credit enhancement to banks that want to avoid the capital cost of provisioning. It may be unattractive to banks that want the tax benefits of provisioning.

To the extent French regulators and accountants consider the asset to be secured if the principal is guaranteed or collateralized, credit enhancement of interest would produce no additional benefit for tax and accounting purposes.

It should be possible to accommodate the tax and regulatory concerns of French banks by structuring credit enhancement to obtain the best possible combination of regulatory and tax effects.
### France

#### Matrix of Regulatory and Tax Treatment of Alternative Debt Reduction Schemes in France

<table>
<thead>
<tr>
<th>Instrument</th>
<th>Accounting Treatment</th>
<th>Tax Treatment</th>
<th>Regulatory Treatment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reduced Rate Loan</td>
<td>Loss not normally recognized.</td>
<td>Reduced interest earnings lead to lower taxable income.</td>
<td>Follows accounting treatment.</td>
</tr>
<tr>
<td>Discount Bond</td>
<td>Asset loss equal to difference between face value and new exchange value. If discount is larger than reserve level, loss has to be charged against reserves.</td>
<td>Tax loss may be recognized equal to difference between face and market value of loan depending on reserve level. Subsequent losses to be calculated at capital gains rate, unless exemption from Treasury is received as in the Mexico financing package.</td>
<td>Loss is charged against loan-loss reserves, hence upfront decline in capital.</td>
</tr>
<tr>
<td>Debt/Equity Conversion</td>
<td>Must be accounted for at fair value. Accounting loss must be charged against provisions.</td>
<td>Fair value used to determine tax liability.</td>
<td>Converted loan substracted from country exposure for purposes of mandatory reserving. Fair value accounting used.</td>
</tr>
<tr>
<td>Buyback</td>
<td>Fair Value.</td>
<td>Tax loss depending on difference between accounting loss and reserve level.</td>
<td>Loss recognized equal to between face value of existing asset and cash received.</td>
</tr>
<tr>
<td>New Money</td>
<td>Accounted for at face value with LLRs at same level as existing exposure in order to achieve required reserve level.</td>
<td>Incremental LLRs are tax deductible. LLRs currently included in regulatory capital.</td>
<td>LLRs currently included in regulatory capital.</td>
</tr>
<tr>
<td>Interest Capitalization</td>
<td>Income might be recognized on interest capitalized and must be provided against at 100%.</td>
<td>Capitalized interest might be taxed.</td>
<td>Specific reserve against capitalized interest is out of capital so regulatory treatment is same as accounting.</td>
</tr>
<tr>
<td>Currency Loan at Current Exchange</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
FRANCE

ANNEX 1: ACCOUNTING TREATMENT OF INTERNATIONAL LOANS ENCOUNTERING REPAYMENT DIFFicultIES

Traitement comptable des créances internationales faisant l'objet de difficultés de recouvrement

A. Enregistrement Comptable

1. Les prêts demeurent classés parmi les actifs sains tant que le plan de remboursement - initial ou modifié à la suite d'un accord formel de rééchelonnement - est respecté par le débiteur.

2. Les échéances impayées doivent être transférées dans les créances immobilisées à l'issue d'une période qui ne peut excéder trois mois.

3. Lorsqu'une créance - qu'il s'agisse de la part correspondant à des intérêts échus ou du principal - a fait l'objet d'une provision, à tout le moins la partie provisionnée de ladite créance est à classer parmi les actifs douteux.

B. Régime des Provisions

1. Les intérêts échus demeurés impayés doivent, lorsqu'ils ont été enregistrés dans les produits, faire l'objet d'une provision d'égal montant, au plus tard à l'expiration d'un délai de trois mois.

2. L'obligation de provisionner les intérêts échus impayés, que l'on peut considérer comme minimale, n'exclut pas que des provisions soient constituées sur le capital.

En particulier, les échéances impayées en capital devraient être provisionnées à l'expiration d'une période de trois mois, sauf s'il apparaît qu'un accord sur le rééchelonnement de la dette concernée est sur le point d'être conclu.

En outre, s'il existe un doute sérieux sur la capacité ou la volonté du pays emprunteur d'honorer la partie non échue de la dette, l'existence d'un accord de rééchelonnement total ou partiel n'étant qu'un des éléments d'appréciation de la situation, il est de bonne gestion de procéder à la constitution de provisions supplémentaires sur les échéances à venir.
Monsieur le Président,

J'ai l'honneur de vous communiquer, ci-joint, une lettre confidentielle du Directeur du Trésor relative à la constitution en franchise fiscale de provisions au titre des risques pris sur certains pays dont la situation des paiements extérieurs paraît compromise ou menacée.

Ainsi que le précise le Directeur du Trésor, les établissements pourront prendre contact avec les services de la Commission Bancaire afin d'y obtenir les informations nécessaires.

Vous noterez que la concertation menée entre le Ministère de l'Economie, des Finances et de la Privatisation et l'Association Française des Banques a permis d'aboutir à une solution mettant les banques françaises en meilleure position pour faire face aux problèmes que leur pose l'endettement des pays en développement.

Je vous prie d'agréer, Monsieur le Président, l'expression de mes sentiments très distingués.

J.J. BURGARD

P.J.
Paris, le 3 mars 1987

Ministère de l’Economie
Des Finances et de la Privatisation
Direction du Trésor
Le Directeur

Monsieur le Président,

Lors d’un récent entretien, je vous ai indiqué qu’à la suite de la concertation menée depuis plusieurs mois entre mes services et la communauté bancaire au sujet des conditions de mise en œuvre de la stratégie de traitement de la dette internationale, un dispositif venait d’être arrêté par le Ministre d’État concernant la couverture des risques-pays par les établissements de crédit résidents.

Ce dispositif répond à l’objectif d’accompagner l’effort de provisionnement des établissements de crédit sur certains pays dont la situation de paiements extérieurs paraît compromise ou menacée.

Il convient à autoriser dorénavant la constitution en franchise fiscale des provisions au titre du risque-pays concernant:

- les pays en difficultés de paiements avérés;
- ceux ayant conclu un accord de rééchelonnement bancaire ou en Club de Paris et n’ayant pas retrouvé l’accès aux marchés;
- les pays à haut risque du fait d’un service de la dette important au regard du montant de leurs exportations de biens et services.

Comme il est d’usage en la matière, chaque établissement pourra, s’il le souhaite, se rapprocher des services de la Commission Bancaire afin d’y obtenir les informations nécessaires.

Je tiens à souligner que ce dispositif devrait contribuer à renforcer l’assise financière de notre place dans un contexte international qui reste difficile. Il devrait mettre notre communauté bancaire en état d’assumer pleinement ses responsabilités dans le cadre d’un traitement ordonné et concerté entre toutes les parties prenantes des problèmes de la dette des pays en développement.

Je vous prie d’agréer, Monsieur le Président, l’expression de ma considération distinguée.

Signé: Daniel LEBEGUE

Monsieur Dominique CHATILLON
Président de l’Association Française des Établissements de Crédit
36, rue Taitbout
75009 PARIS
Monsieur le Secrétaire général,

Vous avez souhaité connaître le point de vue du Secrétariat général de la Commission bancaire en ce qui concerne l'enregistrement comptable des échanges de créances internationales, généralement qualifiés d'"assets swaps". Les solutions suivantes me semblent pouvoir être retenues.

Les créances cédées sortent du bilan du cédant pour leur valeur nominale; les pertes sont constatées dans les comptes de charges "Créances irrécupérables non couvertes par des provisions" et/ou "Créances irrécupérables couvertes par des provisions".

Afin de permettre le suivi et le contrôle de la valeur des créances et des décotes correspondantes, les créances acquises doivent être enregistrées en comptabilité en effectuant, pour chaque opération, une distinction entre la valeur nominale de la créance, inscrite au compte de prêt adéquat, et le montant de la dépréciation -ou décote- inscrit en totalité dans un compte correcteur d'actif. Pour la présentation des états périodiques et lors de chaque arrêté comptable, ce compte créditeur est fusionné avec le compte d'actif correspondant, créance par créance.

Par la suite, si la créance acquise devait être remboursée pour un montant supérieur à la valeur nette comptable enregistrée lors de son acquisition, la différence serait portée en compte 762 "Récupération sur créances amorties". Toutefois, le compte correcteur serait préalablement soldé par le crédit du compte de créance et la différence virée au compte de résultats serait égale à l'écart entre la valeur nominale de la créance diminuée du compte correcteur - ou valeur nette comptable - et le montant remboursé.

Le volume assez variable et relativement limité des opérations d'échanges de créances internationales, ainsi que la forte volatilité des taux de décote sur ce marché ne permettent pas de conclure que ces derniers reflètent fidèlement les perspectives de recouvrement des concours sur pays à risque. En conséquence, les décotes constatées sur le marché d'échanges de créances à l'occasion d'opérations particulières ne sauraient dispenser les établissements de tenir compte de la solvabilité finale des pays débiteurs.

Il n'y a pas lieu, lors de cessions ou d'échanges de créances internationales, de reprendre en produits les provisions antérieurement calculées en fonction des actifs cédés, s'il apparaît que l'ensemble des provisions constituées par l'établissement créancier au titre des pays éprouvant des difficultés de remboursement n'atteint pas le niveau global souhaité par la Commission bancaire. En effet, si le montant de provisions nécessaires est calculé pays par pays, d'après les taux moyens constatés par la Commission bancaire sur la place, l'appréciation de la situation d'une banque au regard du problème posé doit être effectuée sur un plan général. C'est pourquoi les provisions pour risques-pays sont d'une nature particulière. N'ayant pas de caractère spécifique, elles ne doivent pas être considérées comme affectées à une créance déterminée; elles constituent en réalité une première ligne de défense des fonds propres et, à cet égard, le taux de couverture global ne doit pas devenir inférieur à celui qui est indiqué par la Commission bancaire.
Veuillez agréer, Monsieur le Secrétaire général, l’assurance de ma considération distinguée.

J.L. Butsch

COMMISSION BANCAIRE
Le Secrétaire General
Monsieur le Président,

Par lettre du 30 octobre dernier, je vous demandais de bien vouloir informer la Profession du traitement comptable et prudentiel qu'il convenait d'appliquer aux créances sur le Mexique contractées dans le cadre de l'accord du 13 septembre 1989.

Depuis lors, plusieurs établissements de crédit m'ont interrogé sur l'interprétation qui devait être donnée de la disposition relative à l'apport de "new-money". Celle-ci stipule que "les nouveaux prêts n'auront pas à être provisionnés si le taux global de provisionnement de l'établissement prêteur est conforme au taux moyen constaté sur la Place et si le débiteur mexicain continue de respecter ses engagements". Je précise que le non-provisionnement des nouvelles créances n'a, bien entendu, aucun caractère obligatoire. Au contraire, il peut apparaître de bonne gestion de couvrir les nouveaux prêts dans les conditions de provisionnement suivies jusqu'ici à la demande de la Commission bancaire.

Ainsi un établissement dont le taux de provisionnement, avant versement du "new money", est égal au taux moyen constaté sur la Place, est parfaitement fondé à due concurrence. Ce taux moyen constitue, de façon générale, pour la Commission bancaire un taux minimal. Il va de soi que, pour les mêmes raisons de prudence, il est loisible à un établissement dont le taux de provisionnement excède ce minimum de provisionner les nouveaux prêts dans les mêmes conditions que les autres créances souveraines.

En vous remerciant de bien vouloir porter cette lettre à la connaissance de vos adhérents, je vous prie d'agréer, Monsieur le Président, l'assurance de ma considération distinguée.

Larosière

Monsieur le Président
de l'ASSOCIATION FRANCAISE
DES ETABLISSEMENTS DE CREDIT
36 rue Taitbout
75009 PARIS
Dans le cadre de l'accord intervenu le 13 septembre dernier entre le Mexique et les banques créancières, trois options ont été retenues:

1. Un échange de créances commerciales des obligations à taux d'intérêt normal après acceptation d'une décote de 35% ;

2. Un échange de créances commerciales sans décote sur le principal contre des obligations portant un taux d'intérêt réduit ;


Afin de permettre aux établissements de crédit français concernés de choisir parmi les trois options qui ne sont pas exclusives l'une de l'autre, il me paraît utile de vous faire connaître le traitement comptable et prudentiel qu'il conviendra d'appliquer à chacune de ces options.

Dans le cadre des options 1 et 2, la cession des créances sur le Mexique constitue une cession parfaite au sens de l'article 2 du règlement no. 89-07 du Comité de la réglementation bancaire. En conséquence, les créances cédées cessent de figurer au bilan de l'établissement cédant.

Lors de l'application de l'option 1, la perte provenant de la cession, égale à la différence entre le prix d'acquisition des obligations et la valeur comptable des créances cédées, est enregistrée au compte de résultats. En revanche, aucune moins-value de cession n'apparaît pour l'option 2, dans la mesure où les créances sont cédées sans décote sur le principal.

Les obligations acquises en échange des créances cédées sont comptabilisées, selon l'intention de l'établissement, soit dans le portefeuille de transaction, soit dans le portefeuille de placement.

Je vous rappelle à cet égard que seuls les titres négociés sur un marché dont la liquidité peut être considérée comme assurée, conformément à l'article 2 du règlement no. 88-03 du Comité de la réglementation bancaire, peuvent être enregistrés dans le portefeuille de transaction, et être ainsi évalués au cours du jour le plus proche de la date d'arrêté.

Lorsque les titres sont comptabilisés dans le portefeuille de placement, ils sont évalués, lors de l'arrêté comptable, au plus bas de leur prix de marché (ou de leur valeur probable de négociation) et de leur prix d'acquisition. Toutefois, les titres destinés à être durablement conservés et dont le remboursement à l'échéance est intégralement garanti, ne font pas l'objet de provisions pour dépréciation, dès lors qu'ils sont, soit financés par des ressources globalement adossées en durée, soit couverts en taux dans les conditions décrites à l'article 4 du règlement no. 88-02 du Comité de la réglementation bancaire.
Pour les options 1 et 2, la reprise des provisions antérieurement constituées dépend de la situation dans laquelle se trouve l'établissement concerné au regard des risques-pays. En effet, je vous rappelle qu'il n'y a pas lieu, lors de cessions ou d'échanges de créances internationales, de reprendre en produits les provisions antérieurement calculées sur les actifs cédés, s'il apparaît que l'ensemble des provisions constituées par l'établissement créancier au titre des risques sur des pays éprouvant des difficultés de remboursement n'atteint pas le niveau déterminé par la Commission bancaire pour l'ensemble des risques-pays (taux moyen de la place avant l'opération mexicaine de conversion).

Les titres acquis n'auront pas à faire l'objet de nouvelles provisions au titre du risque-pays pour autant que le risque mexicain ne se dégraderait pas de façon significative. En revanche, les provisions antérieurement constituées sur les créances cédées devront au minimum être maintenues au niveau de la différence entre le taux moyen de provisionnement des créances mexicaines constaté sur la place de Paris à fin décembre 1988 et le taux de décote consenti lors de l'échange; ce niveau pourra être abaissé à due concurrence des corrections de valeur pratiquées comptablement, en raison des fluctuations du cours des titres ou de leur valeur probabile de négociation. Il pourra également être diminué au fur et à mesure que la valeur capitalisée de la garantie croîtra, au prorata de cet accroissement de valeur.

En ce qui concerne l'option 3, les nouveaux prêts n'auront pas à être provisionnés si le taux global de provisionnement de l'établissement prêteur est conforme au taux moyen constaté sur la Place et si le débiteur mexicain continu de respecter ses engagements.

Je vous remercie de bien vouloir porter la présente lettre à la connaissance de vos adhérents.

Veuillez agréer, Monsieur le Président, l'assurance de ma considération distinguée.

/s/ J.de LAROSIERE

Monsieur le Président
de l'ASSOCIATION FRANCAISE
DES ETABLISSEMENTS DE CREDIT
36 rue Taitbout, 75009 PARIS
FRANCE

ANNEX 2: PRESS RELEASE FROM CREDIT COMMERCIAL DE FRANCE

CREDIT COMMERCIAL DE FRANCE

Le 8 mars 1989

COMMUNIQUE DE PRESSE

Le Crédit Commercial de France se sépare d’une partie très importante de ses risques souverains

Le groupe CCF a réalisé à nouveau, en 1988, un effort exceptionnel de provisionnement de ses risques souverains en consacrant plus de 1.220 millions de Francs aux dotations nouvelles et en portant en conséquence son taux de provision global à environ 47% en termes comptables et à environ 58% en termes économiques (en prenant en compte les possibilités de récupération fiscale au titre des provisions non déduites de l’assiette fiscale). Ce niveau est considéré satisfaisant dans les circonstances présentes.

Tirant parti de cet effort, le CCF a décidé de se séparer d’une partie très significative de ses risques pays, pouvant atteindre, à terme, 60% du portefeuille du groupe, avec le souci d’une protection efficace de son bilan et d’une meilleure visibilité de l’évolution de son résultat net.

Ne souhaitant pas, pour des raisons de principe, aussi bien que de bonne gestion financière, le recours au marché secondaire des créances restructurées, qui n’a guère de signification économique car il est peu liquide et déjà très déséquilibré, le CCF a décidé d’innover en réalisant cette cession par le moyen d’un schéma original, inspiré du principe de la titrisation qui lui permettra de substituer aux risques pays cédés un actif de très bonne sécurité.

Ce schéma vient d’être mis en place, le 8 mars, pour une première tranche et se présente de la façon suivante:

(a) Le CCF a cédé un portefeuille de risques souverains, d’une valeur faciale de 500 millions de Dollars US (3,15 milliards de FF), à une société financière “Financial Overseas Holdings” (FINOV), elle-même contrôlée par la Royal Bank of Scotland Trust Company (C.I.) Limited, agissant en tant que trustee.

Le prix de vente de ces créances a été fixé à un niveau global moyen de 46% du nominal, pour tenir compte notamment du rendement des risques cédés. Compte tenu du niveau normal de dotations qui sera consacré cette année aux risques pays, cette transaction n’affectera pas le résultat du CCF en 1989.

(b) Simultanément, la société FINOV a émis un emprunt d’un montant total de 500 millions de Dollars US, à un terme de 25 ans, qui est initialement entièrement souscrit par le CCF.

Le produit de cette émission, net du montant nécessaire à l’achat des risques souverains, a permis à FINOV d’acquérir des titres de première qualité permettant de
garantir le remboursement de l'emprunt ainsi qu'une rémunération minimum : le nouvel actif détenu par le CCF n'a donc pas à être provisionné.

Cette rémunération minimum garantie avoisine 50% du Libor. La rémunération effective est fonction de l'ensemble des intérêts perçus par la société FINOV. Elle excède actuellement sensiblement le taux du Libor.

Il est précisé que le CCF, en tant que porteur de l'emprunt émis par FINOV conservera en outre un droit à rémunération supplémentaire, en fonction de la croissance de la valeur de l'ensemble des actifs de FINOV.

Ce schéma a fait l'objet d'une expertise approfondie sur le plan juridique, fiscal et comptable. Il a été approuvé par les Commissaires aux comptes du CCF. Il a reçu l'accord des autorités concernées.

* * *

Le CCF a l'intention de mettre en place, sur des bases comparables, d'autres tranches de cette opération, qui pourraient porter les risques souverains cédés à un montant nominal pouvant atteindre un milliard de Dollars US. A l'issue de l'ensemble de ces cessions, les risques souverains conservés au bilan du groupe resteront naturellement provisionnés à plus de 50%.

Le CCF aura ainsi renforcé son bilan et amélioré la visibilité de son résultat net, l'actif nouveau détenu par lui pouvant, au-delà de la sécurité de son remboursement, être très clairement apprécié en fonction de son rendement annuel. Il est à cet égard précisé qu'il sera fait particulièrement mention de cet actif et de ses performances dans le rapport annuel de la Banque.

Il va de soi que le CCF reste solidaire de la stratégie définie au niveau international pour traiter le problème de la dette. Tout en reconnaissant la nécessité de rechercher de nouvelles approches volontaires pour contribuer à le résoudre, il demeure convaincu que les engagements financiers pris par les Nations souveraines doivent être honorés. Cela explique que le CCF ait exclu la cession de ses créances sur le marché secondaire, et ait souhaité demeurer intéressé à leur bonne fin.
FRANCE

ANNEX 3: LETTERS FROM FINANCE MINISTRY TO THE FRENCH BANKING ASSOCIATION

LE DIRECTEUR DU TRESOR

Paris, le 10 octobre 1989

Monsieur le Président et Cher Ami,

Dans votre lettre du 10 juillet dernier, vous m'avez fait part de vos observations quant aux aspects fiscaux des opérations de conversion de créances que les banques françaises pourraient effectuer, dans le cadre de plans de réduction de la dette des pays en développement tel que celui que le Mexique et ses principales banques créancières viennent de mettre au point.

Je tiens à vous indiquer que Monsieur BEREGOVOY, Ministre d'Etat, Ministre de l'Economie, des Finances et du Budget, a décidé d'aménager le régime fiscal des provisions pour risque-pays dans le cas des opérations de réduction de dettes.

Ainsi, afin de faciliter la participation des banques françaises à de telles opérations, les provisions excédentaires sur les créances converties, c'est-à-dire le montant net à réintégrer après déduction de la décote, seront réintégrées dans les résultats des banques sur une durée égale à celle des nouveaux titres obligatoires émis par ces pays en échange des créances anciennes.

Dans le cas des opérations concernant la dette du Mexique, cette réintégration s'effectuera donc sur trente ans.

Cette décision me paraît répondre de manière très satisfaisante aux observations et suggestions que mentionnait votre lettre.

Je vous prie d'agréer, Monsieur le Président, l'assurance de ma considération distinguée, et de mon meilleur souvenir.

Signé: Jean-Claude TRICHER

Monsieur Marc VIENOT
Président de la Commission des Affaires Internationales
Association Française des Banques
18, rue Lafayette - 75009 PARIS
ASSOCIATION FRANÇAISE DES BANQUES
Paris, le 28 juin 1990

DIRECTION DES AFFAIRES INTERNATIONALES

COMMISSION DES AFFAIRES INTERNATIONALES

Le Président

Monsieur le Directeur,

Par lettre du 10 octobre 1989, vous aviez bien voulu me faire part de la décision prise par le Ministre d’Etat, Ministre de l’Économie, des Finances et du Budget, d’aménager le régime fiscal des provisions pour risques pays dans le cas des plans de réduction de la dette des pays en voie de développement, tel que celui mis au point pour le Mexique.

Pour faciliter la participation des banques françaises aux opérations concernées, il avait été admis que la provision excédentaire sur ces créances converties, c’est-à-dire le montant net à réintégrer après décote, soit reprise dans les résultats sur une durée égale à celle des nouveaux titres obligataires remis en échange. Certaines options offertes dans le cadre du réaménagement de la dette vénézuélienne comportent des modalités comparables à celles arrêtées pour le Mexique ; il est donc justifié que le même traitement fiscal leur soit applicable.

L’accord vénézuélien présente cependant la particularité d’offrir, par ailleurs, deux options non assorties de la clause essentielle que constitue la garantie de remboursement des capitaux d’emprunt renégociés, cette garantie consistant, par exemple, à adosser les titres issues de la conversion à des obligations à coupon zéro du Trésor américain ou du Trésor d’autres pays.

La première de ces options prévoit l’échange des créances contre des obligations d’une durée de dix sept ans sans décote, avec réduction temporaire des taux d’intérêt pendant les cinq premières années, ces taux étant portés à 7/8 au dessus du LIBOR pour les années suivantes.

Dans l’autre option, l’opération de conversion est assortie d’un apport d’argent frais, égal à 20% des créances converties, contre remises d’obligations d’une durée de quinze ans.

L’absence de toute garantie de remboursement a pour conséquence de ne pas modifier la nature du risque encouru qui se trouve aggravé, dans la deuxième option, par l’apport complémentaire d’argent frais.

Elle justifie l’assimilation des titres issus de la conversion, ou nouvellement créés, aux créances antérieurement détenues : en conséquence, la provision pour risques attachée à ces créances ne devrait pas faire l’objet d’une réintégration, même échelonnée sur la durée de vie des titres issue de la conversion, et les obligations émises en contrepartie de l’apport d’argent frais devraient ouvrir droit à la constitution d’un complément de provision pour risques pays.
Au demeurant, la même solution devrait prévaloir en matière comptable, la provision pour risques attachée aux titres obligatoires étant maintenue au passif du bilan.

Il nous paraît important que ces mesures d’adaptation soient décidées afin de ne pas dissuader les banques françaises d’exercer leur choix en faveur des formules nouvelles de réaménagement, voulues par les Pouvoirs Publics. En tout état de cause, leur décision doit intervenir avant le 15 août prochain.

J’espère que vous voudrez bien accepter de vous faire à nouveau notre interprète auprès des autorités compétentes pour faire réserver une suite favorable à notre demande.

Veuillez agréer, Monsieur le Directeur, l’assurance de ma considération distinguée.

M. VIENOT

M. Jean-Claude TRICHET
Directeur du Trésor
Ministère de l’Économie, des Finances et du Budget
139, rue de Bercy
Télédoc 645
75572 PARIS CEDEX 12
Monsieur le Président,

Par lettre en date du 28 juin dernier, vous m’avez fait part de vos observations sur les aspects fiscaux des opérations de conversion de créances que les banques peuvent effectuer dans le cadre des plans de réduction de la dette des pays en développement, tel que celui que le Vénézuela et ses principales banques créancières viennent de convenir.

Je puis vous indiquer que Monsieur Bérégovoy, Ministre d’Etat, Ministre de l’Économie, des Finances et du Budget, a décidé que, dans tous les cas de conversion en obligations s’inscrivant dans le cadre de la mise en œuvre d’une option d’argent frais ou de réduction de dette d’un accord bancaire, les provisions déjà constituées sur les créances existantes seront réintégrées sur la durée de vie des obligations.

Bien entendu, les établissements bancaires peuvent à tout moment opter pour la constitution sur ces obligations de provisions soumises au régime des plus et moins values à long terme, en réintégrant simultanément le solde des provisions antérieures.

Cette décision me paraît largement prendre en compte les observations que mentionnait votre lettre.

Je vous prie d’agréer, Monsieur le Président, l’assurance de ma considération distinguée.

Jean-Claude TRICHET

Monsieur Marc VIENOT
Président de la Commission des Affaires Internationales
Association Française des Banques
18, rue Lafayette
75009 PARIS
Germany

Bank supervision in the Federal Republic of Germany is placed under the dual authority of the Federal Bank Supervisory Office (the FBSO) and the Deutsche Bundesbank. The FBSO has the primary responsibility for the supervision of banks but it exercises its supervisory powers in close collaboration with the Bundesbank. In practice, however, many of the tasks that might be carried out by supervisors in some other creditor countries are carried out by auditors in Germany. Banks are required by law to appoint independent auditors. Within a month after the auditor's appointment the FBSO has the right to request that another auditor be appointed.

German banks create three types of loan loss reserves against their loans. These three types are: specific reserves, general loan loss reserves and hidden reserves. Specific reserves are tax deductible and excluded from regulatory capital. General loan loss reserves and hidden reserves are also excluded from regulatory capital but are, for the most part, not tax deductible. Most large German banks have specific reserves equal to over 60% of their exposure to developing countries.

Until the end of tax year 1988 German banks could also deduct a general provision from taxable income. The permissible tax deductible provision was a set percentage of certain categories of assets. These tax and regulatory rules were recently repealed, and for tax years 1989 onward banks may only deduct general loan loss provisions for certain categories of assets mainly based on loan loss experience. German banks are required to capture excess general provisions over the three tax years ending after December 30, 1988. One-third of the reserve established in tax year 1988 should be recaptured in each of the tax years 1989, 1990, and 1991, so that no tax deductible reserve of this type remains in tax year 1992.34 General provisions are not included in regulatory capital.

Throughout the debt crisis German regulatory authorities have maintained their traditional reluctance to issue specific guidance with respect to the regulatory and accounting treatment of transactions. This remains an issue primarily between a bank and its auditor.

Institutional Framework

Bank supervision in the Federal Republic of Germany is placed under the dual authority of the Federal Bank Supervisory Office (the FBSO) and the Deutsche Bundesbank. The FBSO has the primary responsibility for the supervision of banks but it exercises its supervisory powers in close collaboration with the Bundesbank. Although it operates with a great deal of independence, the FBSO comes within the general responsibility of the Minister of Finance and is, in theory subject to its instructions. Regulations on capital adequacy and liquidity are issued by the FBSO after it has obtained the full agreement of the Bundesbank. The FBSO's powers include licensing and the ability to audit a bank's accounting records. In practice, however, the FBSO relies on the work of the bank's external auditors. Use of external auditors is required for all banks. Section 27 of the Banking Law requires that the annual accounts, the books and the annual report are audited by an external auditor. Banks must notify the FBSO immediately of their appointment of an auditor. Much of what the external auditors are required to do represents regulatory compliance procedures and includes:

(i) an examination of the financial statements

34 Due to the ability of German banks to shift reserves the recapture of general provisions of 1989, 1990 and 1991 may not always give rise to a net addition to the taxable income.
(ii) compliance with reporting requirements regarding:

- loans to related parties (defined in the Bank Act)
- loans in excess of 15% of regulatory bank capital;
- loans in excess of DM 1 million
- acquisitions or disposals of significant investments (those investments in which the bank holds greater than 10% of the investment's capital or where there has been a change in ownership of 5% or more).
- ratio requirement for fixed assets.

All reports are submitted to the credit institution, the FBSO, and the Bundesbank, and must communicate any audit exceptions or irregularity observed in the audit process. They must also provide a description of the financial situation of the bank (including its liquidity position) as of the balance sheet date and its profitability trends (including its credit practices) for the year then ended.

Although the FBSO has the primary responsibility for the supervision of banks, it exercises its supervisory powers in close coordination with the Bundesbank which has a large supervisory staff. The Bundesbank's primary responsibility is for the day-to-day management of monetary policy as well as for current banking supervision by collecting and processing bank supervisory returns. While the Bundesbank is obliged to support the general economic policy of the government, its independence is guaranteed by a provision in the Bundesbank Act of 1957 which states that in case of a conflict with the central bank's primary role, its legal duties take precedence. This gives the Bundesbank an independence unique among central banks in the OECD zone.

The bank supervisory system is rule based. The basic law is the Banking Act of the Federal Republic of Germany (Das Gesetz über das Kreditwesen) of July 1961 with significant amendments in 1976 and 1984 (das Dritte Gesetz zur Anderung des Gesetzes über das Kreditwesen vom 20. Dezember 1984). German accounting conventions and tax laws are extremely complicated. The basic laws determining German banks' financial reporting are the Commercial Code ("Handelsgesetzbuch"), the Stock Corporation Law ("Aktiengesetz"), which governs public companies and the Publication Law ("Publizitätsgesetz") which governs private limited liability companies. In the case of banks, all these laws are secondary to the Banking Act. The most important professional association governing accounting conventions is the Wirtschaftsprüferkammer. However, the principal influence on bank reporting are the FBSO's reporting guidelines.

As discussed below, there are few specific rules relating to country risk. The FBSO and the Bundesbank do not attempt to provide a comprehensive or independent view of the financial prospects of individual debtor countries. Commercial banks are responsible for independently monitoring and evaluating country risk. However, since the July 1986 amendments of the Banking Act, banks submit to the FBSO and the Bundesbank, on a periodic basis, comprehensive consolidated information on country risk. A main purpose of this reporting is to monitor more effectively the activities of foreign subsidiaries, particularly in Luxembourg, through which a substantial portion of international loans has been booked.
Disclosure Guidelines

The annual reports submitted to the FBSO by external auditors must follow specific guidelines for format and content. When auditing a bank's annual accounts, such external auditors are also required to look generally into a bank's affairs to ascertain whether it has complied with all such guidelines. Generally reports submitted to the FBSO and Bundesbank are not made public. German banks are required to make public balance sheets and income statements for each accounting period. However, due to the intricacies for German accounting practices (especially the use of hidden reserves), many credit analysts feel that these public documents have little value in understanding a German bank's real financial position.

In accordance with the legal requirement imposed by the German Banking Act Amendments (mentioned above), German banks submit to the FBSO and the Bundesbank on a periodic basis comprehensive consolidated information on country risk. Audit reports must also contain detailed information on country risk. These reports are not made public. Major credit analysts have, however, made public detailed information on the exposure of German banks to the highly indebted countries.

Nonaccrual Loans

No disclosure requirement of interest accrual policies exists for the published annual report. However, in the long from audit report (which is not published but is sent to the FBSO), a detailed description of the accounting treatment must be included.

A 1977 pronouncement by the banking committee of the German Institute of Auditors stated that interest on doubtful loans should be accrued and then, if applicable, written off as a bad debt, unless receipt of interest is seriously in doubt. In this case, the FBSO requires that the total amount of doubtful interest income not accrued in the annual financial statements be disclosed in the (unpublished) long form audit report. German auditors interviewed for this report expressed different opinions about the appropriate policies for the accrual of interest on sovereign loans. It seems that accounting practices with respect to nonaccrual loans are not uniform in Germany.

There is no discussion of interest accrual policies on past due loans or renegotiated/reduced rate loans in the published annual reports of German banks.

Tax and Regulatory Treatment of Loan Loss Provisions

Provisions for doubtful and bad loans are to a considerable extent determined by tax law. In Germany, as in the rest of Continental Europe, there is a somewhat tighter link between tax and book accounts.

German banks create three types of loan loss reserves or "valuation allowances."

They are:

(i) Specific Loan Loss Reserves (Einzelwertberichtigungen)
(ii) General Loan Loss Reserves (Pauschalwertberichtigungen), and
(iii) Undisclosed Reserves or "hidden reserves."

The specific loan loss reserve, or "individual valuation allowance," is the reserve that is established against individual loans and contingent liabilities. These reserves are
established on a case-by-case basis whereby individual loans or receivables are evaluated as to their future collectibility. Specific loan loss reserves are not included in regulatory capital. The allowance may vary from a low percentage such as 5% of face value to a complete write-off if the loan or receivable is unsecured. Specific allowances are always offset directly against the asset balance.

Broadly, banks assume that any provision against a specific doubtful or bad loan is tax deductible. The justification for specific bad debt provisions is, in principle, the same justification that a cautious and prudent accountant would use to set up a specific reserve for book purposes. Insolvency, over-indebtedness and the necessity to start legal proceedings would normally justify specific reserves for bad debts. Most German banks would provide against a loan if it became non-performing. Where the repayment of the principal amount of a loan has been deferred by agreement, the tax authorities would generally take the position that no specific provision for bad debts is justified. The exception to this practice has been the tax treatment of sovereign loans (discussed below). Banks are subject to regular tax audits, but there may be a delay of anything up to six years between a provision and the subsequent agreement or disagreement of the tax authorities.

The credit risks relating to sovereign debts are regarded as specific rather than general risks. Loan loss reserves against country risks are, therefore, specific reserves netted from the loans in question. There are currently no legal or regulatory guidelines detailing countries for which provisions must be set up, or the percentage write-downs which are considered necessary. The FBSO has indicated that adequate provisions must be established, but that it is up to each bank's management and their auditors to decide what is adequate. Industry and authoritative bodies, such as the German Institute of Auditors and the association of private banks, have been reluctant to provide detailed guidance on this subject. As a result of the lack of official guidance, the actual practice among banks becomes very important. Banks and their advisors unofficially compare reserves for sovereign risk. Annex 1 indicates some countries which are currently considered to be significant credit risks, as well as the estimated range of loan loss reserves currently carried by German banks against these countries debt.

There are currently no binding guidelines either in law or from the Banking Supervisory Authorities or Central Bank which prescribe

(a) for which countries provisions must be set up, or
(b) the percentage write-down which are considered necessary.

The Supervisory Authorities take the view that, while adequate provisions must be set up, it is up to the bank's management in consultation with their auditors to decide on what is adequate.

As a result, the actual practice among banks becomes important for each year's closing and both accounting firms and bank managements help themselves by comparing write-downs and the countries concerned from bank to bank and, informally, with statistics on percentage write-downs maintained by the Supervisory Authorities.

The supervisory authorities have also stated that the amount of provision should also be viewed in connection with the particular profit (loss) situation of the bank. It is not felt necessary, for instance, in normal circumstances to increase country risk provisions if the bank would thereby have to report losses for the period.

There remain no legal or regulatory guidelines detailing countries for which provisions must be set up or for which specific provision levels have been established. Federal regulatory authorities have in the past indicated that adequate reserves must be established, but
banks and their auditors are left to decide what is adequate. On average German banks at the end of 1989 had reserved at a level of 60% of their medium- and long-term exposure to troubled debtors. A few banks have established reserves equal to 80% of such exposure. As described in last year's report, German banks are required to submit to the Bundesbank and FBSO details of their reserves and exposure with respect to troubled debtor countries. Table 1 below shows the average reserve levels established by German banks with respect to specific countries.

**TABLE 1**

<table>
<thead>
<tr>
<th>Country</th>
<th>End 1988</th>
<th>End 1989</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>71%</td>
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</tr>
<tr>
<td>Brazil</td>
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</tr>
<tr>
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<tr>
<td>Venezuela</td>
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</tr>
<tr>
<td>Nigeria</td>
<td>74%</td>
<td>70%</td>
</tr>
<tr>
<td>Poland</td>
<td>71%</td>
<td>70%</td>
</tr>
<tr>
<td>Yugoslavia</td>
<td>52%</td>
<td>56%</td>
</tr>
<tr>
<td>South Africa</td>
<td>44%</td>
<td>36%</td>
</tr>
<tr>
<td>Turkey</td>
<td>13%</td>
<td>12%</td>
</tr>
</tbody>
</table>

In Germany, provisions against sovereign risk are generally considered to be tax deductible. In one court case, a lower Federal court has ruled that in the case of a loan to the Polish state bank, Bank Handlowy, a 100% provision against unpaid interest and a 50% provision against principal were tax deductible.

The Ministry of Finance has also provided some guidance on the tax deductibility of provisions in the form of three letters. The first, on April 23, 1979 regarding Turkey, said that the difficult economic and balance of payments situation of Turkey and especially the halt on foreign currency transfers have to be considered when evaluating loans to Turkish customers. The second, issued on March 7, 1983, dealt with sovereign and country risk loans in more detail. In this letter, the Federal Ministry of Finance confirmed that the banks and their auditors should accept bad debt reserves “which are necessary for an evaluation which reflects the principles of cautiousness and the going concern principle.” The letter said that the total economic situation of the country should be taken into account including development of the current account balance, government measures for adaptation of the economic situation, standby credits of the IMF, readiness of international banks to given further loans, raw material and other resources, debt service quota and debt structure. The Foreign Ministry accepted in the letter that it is difficult to estimate repayment on foreign loans and that, therefore, it should be expected that different banks may value loans to identical borrowers in different ways. The Federal Ministry of Finance also stated in this letter that it is not possible to give official or approved country risk evaluations. In a third letter issued on July 29, 1985, the Federal Ministry of Finance stated that the principles of the letter of March 7, 1983 apply to the industry in general. The letter also confirmed that the Tax Authorities accept the judgement of the Hessian Fiscal Court of September 16, 1983 for loans to Poland.

Prior to December 31, 1988, all German banks were required to set up general loan loss reserves or, overall valuation allowances, in accordance with established percentages of different categories of lending. A 1974 regulation of the FBSO established this as a minimum
reserve requirement for banks. Traditionally, these reserves were regarded as necessary reserves for the latent risks in the credit business and the percentages varied from 0.1% to 1.8% depending on the category of business covered. In a 1974 regulation of the Federal Government, the rates required by the FBSO were accepted for tax purposes as deductible from taxable income.

Taking effect December 31, 1988, the 1974 regulations of the FBSO and the Federal Government were repealed. Paragraph 26 subparagraph 5 of the Banking Act was also repealed. This section of the Banking Act was the legal basis for the 1974 regulation of the FBSO. The section allowed the Federal Minister of Finance, after consultations with the Bundesbank, to issue detailed regulations for the creation of loan loss reserves “necessary to the performance of the functions of the FBSO.” The section also allowed the Federal Minister of Finance to delegate authority to draw up such regulations for the creation of loan loss reserves to the FBSO.

For fiscal years ending after December 31, 1988, banks may only set up tax deductible loan loss reserves for specific categories of assets based on past loss experience.

In addition to specific and general reserves, German banks establish extensive hidden reserves. Section 26a of the Kreditwesegesetz allows German banks “in so far as is necessary according to their reasonable commercial judgement” to set up reserves against special risks pertaining to banking. Section 26a allows banks not to disclose these hidden reserves. They must, however, be disclosed in audit reports to the FBSO. Provisions to these reserves are not deductible from taxable income. The FBSO does not include these reserves in its calculation of regulatory capital. The recently approved Basle guidelines on capital adequacy allows for the inclusion of some hidden reserves in regulatory capital provided they are accepted by the relevant banking supervisor.

The use of hidden reserves allows German banks to report steady profits and can be used to smooth out any fluctuations in earnings. These reserves are built up through the use of various accounting techniques including: (a) the use of historic cost accounting; (b) the adoption of valuation options such as writing down investments, claims and securities counted as part of their current assets at a value lower than that permitted by the relevant commercial regulations; and c) the creation of a excess provisions for bad debts. The high levels of provisioning against specific country risks may be treated or managed by some German banks as if there were hidden reserves. Banks may set up reserves for taxes, other banking risks, and market fluctuations in foreign currency and securities holdings.

None of the above valuation allowances may be included in capital or “liable funds.” However, each of these reserves is netted against assets in calculating capital/asset ratios. The concerns of some German banks with respect to the tax and regulatory treatment of voluntary debt reduction are somewhat different then those of banks in the other countries studied. Due to their high levels of tax deductible provisions, many German banks are likely to be concerned with the possibility that their participation in voluntary debt reduction would force them to recognize taxable gains. In addition, in Germany there is the possibility that German banks would be forced to revalue loans not sold in a particular transaction if the value realized in the sale of some loans was significantly above the net book value of the remaining loans. If many sales are conducted at values above the existing book value, there would clearly be pressure for German banks to raise the net book value of the remaining loans by recapturing reserves into taxable income.

In general, where German banks exchange their loans for another asset, they would be required to fair value that asset. Swaps of debt for collateralized securities or other debt instruments would be recorded at market or fair value. Swaps of debt for equity would also be recorded at the fair value of equity received. Where this cannot be easily determined the market value of the debt exchanged could normally be used.
German banks would probably not be forced to revalue their assets in the case of a reduced rate loan, where the only change in the existing asset was a reduction in interest rate in return for some enhancement. This is, however, still somewhat uncertain.

Other Tax, Accounting and Regulatory Issues

Bearer Bonds in the 1990 Mexican Financing Package

In the context of the 1990 Mexican Financing Package, a specific issue arose with respect to the fact that German banks were unwilling to accept registered bonds. As a result bearer bonds were issued for the German banks. This issue is important due to the fact that bearer bonds are more difficult to restructure than registered bonds and, as a result, add greater rigidity to the country's debt structure than do registered bonds. It also raises a burden sharing issue to the extent that bearer bonds are perceived to be more valuable than registered bonds. In the Costa Rican package such instruments were not created.

Two explanations were given for the fact that German banks received bearer bonds in the context of the Mexican Financing Package. One explanation is that the German banks were faced with legal obstacles to holding registered bonds. It does not, however, appear that there is any legal obstacle that prevents German banks from holding registered bonds. They hold registered bonds of other types.

The second explanation is that German banks preferred the bonds for competitive reasons. The most important reason given is that registered bonds are treated as loans for capital adequacy purposes. In the case of loans and registered bonds, banks are required to maintain capital equal to 5.6% of the face value of the bond. On the other hand, bearer bonds require no capital backing under current German regulatory guidelines. As described below, the current banking regulations relating to capital adequacy and liquidity exclude bearer bonds from the definition of loans that is used for calculating required capital and liquidity. It is important to note that the Basle guidelines, which will become fully effective at the end of 1992, will eliminate this extraordinary treatment of bearer bonds for purposes of measuring capital adequacy and liquidity.

Full capital backing against bearer bonds will be required as of the end of 1992. At that time registered and bearer bonds will receive the same treatment for capital adequacy purposes. However, until the end of 1992 this issue may have important implications for financing packages. The fact that no capital is required on bearer bonds made the bond significantly more valuable to German banks. This issue is now, however, of limited significance due to the EC-Directive on Solvency Ratios and the new German capital guidelines which both eliminate this favorable treatment of bearer bonds.

German banks that have international operations are currently governed by both the German national banking regulation and the Basle guidelines. The fact that these banks pushed hard for the issuance of bearer bonds in the Mexican Financing Package suggests that the German national banking regulations are the binding capital constraint rather than the Basle guidelines for some of these banks. To the extent that this is true, the distinction between bearer and registered bonds may continue to be an issue that is raised by German banks.

Note that the bonds which are listed on the stock exchange will continue to be attractive to German banks because they will continue to be considered as completely liquid for the purposes of calculating a German bank's liquidity, as discussed below in relation to Principles II and III of the FBSO banking regulations.
The advantages of holding bearer bonds for German banks can be appreciated by reviewing the German regulatory framework for capital adequacy and liquidity. According to regulations issued by the Federal Bank Supervisory Office (FBSO) (see Annex 1), and in agreement with the Bundesbank, banks are required to maintain certain ratios related to capital adequacy and liquidity. The ratios are contained in the FBSO regulations as “Principles Concerning the Capital and Liquidity of Banks.” Principle I concerns capital adequacy, and Principles II and III relate to liquidity. The essential elements of the three Principles related to capital adequacy and liquidity are as follows:

Principle I

As of October 1, 1990 Principle I has been effectively amended to take supervisory account of the dynamic trend in the off-balance-sheet transactions that underlie forward contract positions in the broadest. A few of the amendments are relevant for this study. Prior to the October 1, 1990 amendment the “loans and participations” of a bank could not exceed 18 times its liable capital. The new capital guidelines expand the definition of assets to include all “risk assets.” The limit of 18 times liable capital applies mutatis mutandis to banking groups in respect of the ratio “calculated by means of pro rata consolidation between aggregate liable capital and loans”. Under the earlier guidelines, banks paid close attention to what were defined as “loans and participations.” If something did not fall into this category no capital backing was required under the pre-October 1990 rules. Paragraph four of the FBSO regulations, for example, defines a number of categories of loans which require less than full capital backing. For example, loans meeting certain requirements of the Mortgage Bank Act (so long as they do not exceed three fifths of the value of the real estate) are excluded from the Principle I definition of the assets against which capital backing is required. Similarly, credits to the European Community, the European Coal and Steel Community and the European Investment Bank are specifically excluded from the definition of assets against which capital backing is required. Bearer bonds are understood to be excluded from the definition of assets (i.e. “loans and participations”) against which capital backing is required. As a result the German banks, if they are fully leveraged, could, under the pre-October 1990 rules, earn an appreciably higher return from holding bearer bonds than they can from registered instruments. Registered bonds, unlike bearer bonds, were normally treated as loans and, therefore, included as assets in all Principles. Under the October 1990 guidelines the broader category of risk assets includes bearer and registered bonds. As a result, German banks should no longer have this additional incentive to prefer to registered bonds.35

Principles II and III

Principles II and III relate to liquidity. Principle II deals with long-term assets and liabilities. Principle III deals with medium-term assets and liabilities. Principle II requires that a bank’s long-term investments not exceed its long-term financial resources. Principle III requires that medium-term investments not exceed medium-term financial resources. In both cases, the FBSO regulations define assets and liabilities that are to be compared in these calculations. And, in both cases, securities that are listed on a stock exchange are considered to be 100% liquid -- i.e. they are excluded from the list of assets for which corresponding financial resources of a specific maturity are required. Listed shares are considered to be part of assets for purposes of Principle III.

35 Note that banks from all countries tend to prefer bearer over registered bonds because of the fact that bearer bonds are more liquid and more difficult to reschedule.
**Tax Treatment of Bonds vs. Tax Treatment of Loans**

There are reportedly some differences in the tax treatment of bonds and loans. It should be recalled that the financial statements of German banks are binding for tax purposes. There may be some differences in the way loans and bonds are reported in financial statements which influence the tax treatment of these instruments. For example, under certain conditions, investment securities can be stated at cost and not at a lower market value. In this case, the cost basis is also relevant for tax purposes. In the case of loans, the question of a write down (specific risk) or provision (general risk or country risk) arises. The treatment in the commercial balance sheet is binding for tax purposes, with the exception that the fiscal authorities do not accept provisions which they believe are excessive.

**Discount bonds**

In theory discount bonds should be fair valued for tax and regulatory purposes. Some banks may find that discount bonds are more attractive than par bonds because they may believe that it will be easier to persuade the fiscal authorities that a tax deduction should be allowed.

**Par bonds**

In theory par bonds should be treated as discount bonds for tax and regulatory purposes. This is so because German auditors look through the form of the transaction to the fair value of the asset exchanged. This results in no difference between the two types of bonds for tax and accounting purposes where the bonds have the same market value.

Although in theory there is no difference between the treatment of par and discount bonds for tax and regulatory purposes, some banks reportedly perceive that there is an important "cosmetic" difference. They believe that it will be easier to justify a tax loss to tax authorities in cases where they have accepted principal reduction than where they have accepted interest reduction. Whether or not these beliefs will be borne out in the actual decisions of the relevant tax authorities remains to be seen.

**Buybacks**

Banks should recognize the difference between the tax basis in their original loan and the value of the cash received for tax purposes. Due to the depth of German provisioning some banks may be required to recognize taxable gains upon participation in a buyback.

**New Money**

New money is treated identically to the original loans for tax and regulatory purposes. If the new money comes in the form of bearer bonds there will be some differences in treatment (as described above) of the bonds for capital adequacy and liquidity purposes.

**Interest Capitalization**

In the case of past due interest German banks would be required to recognize new notes received in exchange for interest arrears as tax and book income. The new notes could be fair valued for this purpose. Fiscal authorities might be expected to follow their trend of using the secondary market price in valuing these notes for tax purposes.
In the case of agreements to capitalize future interest due, German banks would be required to recognize the capitalized interest as income for tax and regulatory purposes. The related income would be recognized for tax and commercial basis on a *pro rata temporis* basis.

**Interest vs. Principal Enhancement**

There are no differences in the treatment of enhancement on interest and principal for the purposes of taxation, reserving, disclosure or capital adequacy. In all cases, German regulatory and tax principles suggest that banks and their auditors should look through the form of the transaction to determine the effect of the enhancement on the value of the new instruments received.

German accounting principles allow two different methods of accounting for exchange transactions.

The first method provides for a continuation of the current book value if the asset exchanged without realizing any possible hidden reserves. This means that the asset purchased in the exchange is valued at the net book value of the assets sold in the exchange. However, under this method the valuation of the asset purchased in the exchanged may not exceed the fair value of that asset. If the fair value of the asset received in the exchange is less than the net book value of the exchange, then the asset received must be written down to that extent.

If income taxes must be paid as a result of the exchange, the amount of such taxes can be added to the book value of the assets given up if the fair values of these assets and the assets received are not exceeded.

The second method assumes a sales and purchase transaction with a possible realization of hidden profits. Under this method the asset accepted in the exchange is accounted for at its fair market value. Under this method the new book value of the asset received in the exchange may not exceed the book value of the asset sold in the exchange.

A moment's reflection reveals that these two methods are essentially equal except for the realization of hidden profits which can occur under the second method but not under the first. The question of whether or not a bank wishes to realize hidden profits is driven by tax and reporting considerations.

German accounting principles and practices are mainly determined by a general concepts of prudence. The first method is considered by German auditors to be the more prudent. The second method is influenced by the income tax treatment for exchange procedures. According to German accounting law and GAAP this method is used when the accounting for financial statement and tax record purposes should be equal.
Germany

Matrix of Regulatory and Tax Treatment of Different Financial Instruments

<table>
<thead>
<tr>
<th>Instrument</th>
<th>Accounting Treatment</th>
<th>Tax Treatment</th>
<th>Regulatory Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reduced Rate Loan</td>
<td>Generally, no losses are recognized. Where the interest rate is dropped to an extremely low level or the nature of the asset is fundamentally altered a loss might be recognized.</td>
<td>Same as accounting.</td>
<td>Same as accounting.</td>
</tr>
<tr>
<td>Par Bond</td>
<td>Fair Value</td>
<td>Fair Value</td>
<td>Fair Value</td>
</tr>
<tr>
<td>Discount Bond</td>
<td>Fair Value</td>
<td>Fair Value</td>
<td>Fair Value</td>
</tr>
<tr>
<td>Debt/Equity Conversion</td>
<td>Fair Value</td>
<td>Fair Value</td>
<td>Fair Value</td>
</tr>
<tr>
<td>Buyback</td>
<td>Fair Value</td>
<td>Fair Value</td>
<td>Fair Value</td>
</tr>
<tr>
<td>New Money</td>
<td>Accounted for at face value with LLRs at same level as existing exposure in order to achieve required reserve level.</td>
<td>Incremental LLRs are probably tax deductible.</td>
<td>LLRs currently excluded from regulatory capital.</td>
</tr>
<tr>
<td>Interest Capitalization</td>
<td>Income</td>
<td>Provisions same as on new money</td>
<td>LLRs excluded from regulatory capital.</td>
</tr>
<tr>
<td>Conversion into Local Currency Loan at Current Exchange</td>
<td>Fair value accounting provisions will depend on exchange rate variations.</td>
<td>Same as accounting.</td>
<td>Same as accounting.</td>
</tr>
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</table>
ANNEX 1: PRINCIPLES CONCERNING THE CAPITAL AND LIQUIDITY OF BANKS ISSUED BY THE FEDERAL BANKING SUPERVISORY OFFICE

Announcement of May 15, 1990

Amending the Principles Concerning the Capital and Liquidity of Banks

In agreement with the Deutsche Bundesbank and after consultation of the central associations representing the banks, the Principles Concerning the Capital and Liquidity of Banks - Announcement No. 1/69 of January 20, 1969 (Federal Gazette No. 17 of January 25, 1969), as last amended by the Announcement of September 23, 1988 amending the Principles Concerning the Capital and Liquidity of Banks (Federal Gazette p. 4383) - are amended to read as follows with effect from October 1, 1990:

Principle I shall read as follows:

(1) The risks assets of a Bank (including a building and loan association operated as a unit of dependent legal status) should not exceed eighteen times its liable capital. The following shall be regarded as risk assets:

(a) participations
(b) loans
(c) financial swaps
(d) futures contracts and option rights in fungible underlying instruments.

(2) In the case of banking groups (Section 10a (2) of the Banking Act), the ceiling pursuant to subsection (1) sentence 1 above applies as appropriate to the ratio of total liable capital to total risk assets (other than participations in enterprises belonging to the group), as calculated by the pro rata consolidation method (section 10a (3) of the Banking Act), and to the net differences shown as assets resulting from capital consolidation in accordance with section 10a (3) sentence 4 of the Banking Act.

(3) The following shall be regarded as loans for the purposes of subsection (1) sentence 2 paragraph 2 above:

(1) Bills of exchange in the bank’s portfolio and bills sent for collection from the bank’s portfolio prior to maturity.

(2) Balances with banks and loans and advances to customers (including the trade receivables of banks conducting business in goods).
(3) Risk assets deducted from the borrower’s portfolio which the borrower has transferred to a third party subject to an agreement whereby they are to be retransferred or whereby the borrower must take them back on request.

(4) Assets in respect of which a bank or an enterprise within the meaning of section 10a (2) sentence 5 paragraph 1, 2 or 3 of the Banking Act has concluded leasing contracts as the lessor.

(5) Contingent claims in respect of:

(a) Bills of exchange in circulation drawn by the bank, discounted and credited to borrowers.

(b) Endorsement liabilities on rediscounted bills.

(c) Guarantees, guaranteed bills and cheques, other warranties, and from the provision of collateral for third-party debts.

(d) Unconditional commitments by building and loan associations to settle third-party interim loans granted to savers with building and loan associations.

(4) The assessment basis for counting the risk assets is:

(1) In the case of participations, the book value, less the value adjustments shown as liabilities.

(2) In the case of loans as defined in subsection (3) paragraphs 1 to 3 and paragraph 5 above (other than guarantees for future contracts, option rights and financial swaps), the book value, less the value adjustments shown as liabilities and less the fees booked but chargeable to subsequent accounting years.

(3) In the case of assets leased in accordance with subsection (3) paragraph 4 above, the book value, less the items in respect of the settlement or sale of claims under leasing contracts, up to the book values of the relevant assets leased.

(4) In the case of financial swaps and the guarantees assumed in connection therewith, the principal amount.

(5) In the case of futures contracts, option rights and the guarantees assumed in connection therewith, the bank’s right—on the assumption of actual settlement—to the delivery or receipt of the underlying instrument.

If, in the case of futures contracts or of the exchange of amounts of interest and principal (in the context of financial swaps), all rights and obligations vis-a-vis the same counterparty arising from transactions in the same currencies and with the same value date are regularly netted by novation under the terms of a contractual agreement, the claim arising from the current balance shall be regarded as the assessment basis. Risk assets denominated in foreign currencies shall be converted into Deutsche Mark at the exchange rate ruling on the reporting date (= reporting date rate); instead of the reporting date rate, the bank may, when converting those participations
which it does not treat as an integral part of its foreign currency position, use the exchange rate in
effect at the time they were first entered in its books. For the currencies officially listed on the
Frankfurt Currency Exchange the spot middle rates shall be used, and for other currencies the
middle rates derived from the determinable buying and selling rates on the reporting date shall be
applied.

(5) Financial swaps within the meaning of subsection (1) sentence 2 paragraph 3 above, futures contracts and option rights within the meaning of
subsection (1) sentence 2 paragraph 4 above and guarantees in connection
with these risk assets shall be calculated uniformly, at the bank's discretion,
either by the original exposure method or by the current exposure method;
the bank may switch from the original exposure method to the current
exposure method at any time. If the original exposure method is used, the
risk assets enumerated in sentence 1 above shall be counted at maturity-
related percentages of the assessment basis relevant to them in accordance
with subsection (4) sentence 1 paragraph 4 or 5 above. If the current
exposure method is used, the risk assets enumerated in sentence 1 above
shall be counted at the potential replacement cost, provided that, by marking
to market, this would arise if the counterpart defaulted, then adding a factor
(the "add-on") specified in subsection (6) sentence 2 below to reflect the
potential future increase in risk; no add-on is applied to single-currency
floating/floating interest rate swaps. The amount of the potential
replacement cost is determined by the level of the additional expenditure or
the lower earnings which would result in the event of the establishment of
an equivalent position.

(6) The maturity-related percentages within the meaning of sub-section (5)
sentence 2 above are:

(1) If the replacement cost is due entirely to changes in interest rates,
given a residual maturity

- of up to one year: 0.5%
- of more than one year: 1.0% for each full and incomplete
  year, less 1%

(2) If the replacement cost is due entirely or partly to changes in
exchange rates or other prices, given an original maturity

- of up to one year: 2.0%
- of more than one year: 3.0% for each full and incomplete
  year, less 1%

The "add-on" within the meaning of subsection (5) first half of sentence 3 above, as
a percentage of the assessment basis as defined in subsection (4) sentence 1
paragraph 4 or 5 above, is,

(1) If the replacement cost is due entirely to changes in interest rates,
given a residual maturity

- of more than one year: 0.5%
(2) If the replacement cost is due entirely or partly to changes in exchange rates or other prices, given a residual maturity

- of up to one year: 1.0%
- of more than one year: 5.0%

(7) Of the loans included in subsection (3) above and granted by building and loan associations to savers with them who are neither banks within the meaning of subsection (8) paragraph 6 below or subsection (9) below nor public corporations within the meaning of subsection (10) paragraph 1 below, the following shall be counted at only 70% of their value:

1. Loans granted by building and loan associations under associated savings contracts (including loans granted in accordance with subsection (8) paragraph 2 below).

2. Interim and bridging loans granted by building associations to savers with them pending receipt of a building loan.

3. Contingent claims of building and loan associations in accordance with subsection (3) paragraph 5 (d) above.

(8) Of the risk assets enumerated in subsection (1) sentence 2) above, the following shall be counted at only one-half of their value:

1. Loans serving as cover for communal bonds or communal ship mortgage bonds.

2. Loans satisfying the requirements of section 12 (1) and (2) of the Mortgage Bank Act, to the extent that they do not exceed three-fifths of the value of the real estate.

3. Loans with maturities not exceeding fifteen years secured by ship mortgages satisfying the requirements of section 10 (1) and (4) sentence 2, section 11 (1) and (4), and section 12 (1) and (2) of the ship Mortgage Bank Act, to the extent that they do not exceed three-fifths of the ship or ship under construction.

4. Loans and advances to customers in accordance with subsection (3) paragraph 2, 3 or 4 above, if guaranteed or secured in some other way by public corporations in the area of validity of the Banking Act.

5. Contingent claims on customers in accordance with sub-section (3) paragraph 5 (c) above.

6. Loans in accordance with subsection (3) above to banks domiciled outside the area of validity of the Banking Act.

7. Risk assets in accordance with subsection (1) sentence 2 paragraph 3 or 4 above, where the right to performance is directed towards a bank which is domiciled outside the area of validity of the Banking Act and which was licensed in a country other than those specified in subsection (9) paragraph 2 (a) below.
(8) Risk assets in accordance with subsection (1) sentence 2 paragraph 3 or 4 above, unless the preconditions for the application of a lower weight are satisfied.

(9) Of the risk assets enumerated in subsection (1) sentence 2 above, the following shall be counted at only 20% of their value.

(1) Risk assets in accordance with subsection (1) sentence 2 paragraph 2, 3 or 4 above, where the right to performance is directed towards a bank which is domiciled in the area of validity of the Banking Act (including branches within the meaning of section 53 of the Banking Act, and including banks which are public corporations in the area of validity of the Banking Act).

(2) Risk assets in accordance with subsection (1) sentence 2 paragraph 3 or 4 above, where the right to performance is directed.

(a) Towards a bank which is domiciled outside the area of validity of the Banking Act and which was licensed in a country which is a full member of the Organisation for Economic Co-operation and Development (OECD) or which has concluded special lending arrangements with the International Monetary Fund associated with the Fund’s General Arrangements to Borrow, or

(b) Towards a multilateral development bank in which at least one of the major industrial countries that have joined the fund’s General Arrangements to Borrow participates.

(10) The following shall attract a zero weight:

(1) Risk assets in accordance with subsection (1) sentence 2 paragraph 2, 3 or 4 above, where the right to performance is directed towards public corporations (other than banks) in the area of validity of the banking Act or towards a special fund of the Federal Government.

(2) Risk assets in accordance with subsection (1) sentence 2 paragraph 3 or 4 above, where the right performance is directed towards:

(a) a country which is a full member of the Organisation for Economic Co-operations and Development (OECD) or which has concluded special lending arrangements with the International Monetary Fund associated with the Fund’s General Arrangements to Borrow, or

(b) the central bank of one of these countries.

(3) Risk assets in accordance with subsection (1) sentence 2 paragraph 3 or 4 above, the replacement cost of which is due entirely or partly to changes in exchange rates, if the original maturity of the transaction is less than fifteen calendar days.
(4) Risk assets in accordance with subsection (1) sentence 2 paragraph 4 above, the performance of which is owed or guaranteed by a stock exchange institution.

Principle Ia shall read as follows:

(1) The total amount of certain positions of a bank involving price risks ("risk positions") should not exceed 60% of its liable capital at the close of business of any day.

(2) the following are risk positions within the meaning of subsection (1) above:

(1) The sum of the differences between asset items and liability items is and in gold, silver or platinum metals (precious metals), pursuant to subsections (3) and (4) below,

(2) The sum of the risk coefficients for counting risk-enhancing positions under interest rate futures contracts and interest-rate option contracts (interest rate contract positions), pursuant to subsections (5) to (7) below.

(3) The sum of the differences between delivery rights and delivery obligations under futures and option contracts involving other price risks, pursuant to subsection (8) below.

The risk positions as defined in sentence 1 above should not exceed the following percentages of the bank’s liable capital at the close of business on any day:

(1) The risk position pursuant to paragraph 1, 30%,

(2) The risk position pursuant to paragraph 2, 20%, and

(3) The risk position pursuant to paragraph 3, 10%.

(3) The following are asset items and liability items within the meaning of subsection (2) sentence 1 paragraph 1 above, if they are denominated in foreign currencies or relate to gold, silver or platinum metals in an unprocessed state (i.e. excluding products made of these precious metals).

A. Asset Items

(1) Balances with banks and loans and advances to customers, and balances in foreign currency accounts carried by the Deutsche Bundesbank.

(2) Bills of exchange.

(3) Treasury bills and Treasury discount paper.

(4) Securities, other than shares and other participatory securities.
(5) Stocks of: (a) gold; (b) silver; (c) platinum metals.

(6) Delivery and payment rights under spot and forward transactions, and rights to receive principal amounts under financial swaps.

(7) Rights and contingent rights to the redelivery of items listed under asset items 1 to 6 above which have been sold under repurchase agreements, to the extent that such items are not included in these asset items.

(8) Rights of the bank as an option writer, arising when third parties exercise option rights, to receive the purchase price represented by the strike price and to receive the underlying instrument.

(9) Rights of the bank, arising when exercising its own option rights, to receive the purchase price represented by the strike price and to receive the underlying instrument, to the extent that this reduces a difference which would otherwise exist and be shown as a liability, in accordance with subsection (4) first half of sentence 1 below.

B. Liability Items

(1) Liabilities to banks and other creditors.

(2) Bonds

(3) Own acceptances and promissory notes in circulation.

(4) Delivery and payment obligations under spot and forward transactions, and obligations to pay principal amounts under financial swaps.

(5) Obligations and contingent obligations to re-deliver items listed under asset items 1 to 6 above which have been acquired under repurchase agreements, to the extent that such items are included in these asset items.

(6) Obligations of the bank an option writer, arising when third parties exercise option rights, to pay the purchase price represented by the strike price and to deliver the underlying instrument.

(7) Obligations of the bank, arising when exercising its own option rights, to pay the purchase price presented by the strike price and to deliver the underlying instrument, to the extent that this reduces a difference which would otherwise exist and be shown as an asset in accordance with subsection (4) first half of sentence 1 below.

(4) The differences for determining the risk position as defined in subsection (2) sentence 1 paragraph 1 above shall be calculated separately for each currency and each precious metal; in each case they are formed by the absolute value of the balance computed from the asset items and liability items in accordance with subsection (3) above. Irrespective of how they are shown in the balance sheet, specific value adjustments of asset items in foreign currencies and Deutsche Mark shall be deducted from these items.
When converting asset and liability items denominated in foreign currencies into Deutsche Mark, spot middle rates shall be used for the currencies officially listed on the Frankfurt Currency Exchange and middle rates derived from the determinable buying and selling rates shall be used for other currencies. Asset and liability items in gold shall be converted into Deutsche Mark at the rate obtaining on the Frankfurt Gold Exchange for 12.5 kg bars (1 kg=32 fine ounces). Asset and liability items in silver and platinum metals shall be converted at the rates per fine ounce obtaining on the London Metal Exchange.

(5) The risk coefficients for determining the risk position as defined in subsection (2) sentence 1 paragraph 2 above shall be calculated separately for each currency in a risk-recording system, classified by time, for four consecutive coverage spans, each of which is subdivided into periods of calendar quarters or calendar years. The following are combined to form coverage spans within the meaning of sentence 1 above:

1. The whole of the calendar quarters specified in the second half of sentence 3 below (the short-term coverage span),
2. The five calendar years succeeding the short-term coverage span (the medium-term coverage span),
3. The five calendar years succeeding the medium-term coverage span (the longer-term coverage span), and
4. The three calendar years succeeding the longer-term coverage span (the long-term coverage span).

The duration of the short-term coverage span in the risk-recording system changes over time at the end of each calendar quarter with the compilation of the fixed-interest-rate table in accordance with subsection (7) second half of sentence 2 below; the short-term coverage span which starts with the second calendar quarter following the pertinent reporting date within the meaning of the first half of this sentence comprises:

- as at March 31 the last two calendar quarters of the current year and the four calendar quarters of the succeeding year (six calendar quarters),
- as at June 30 the last calendar quarter of the current year and the four calendar quarters of the succeeding year (five calendar quarters),
- as at September 30 the eight calendar quarters of the two succeeding years (eight calendar quarters),
- as at December 31 the last three calendar quarters of the succeeding year and the four calendar quarters of the next year but one (seven calendar quarters).
(6) In order to determine the risk coefficient of each coverage span, in the various periods thereof risk ratios to be shown as assets or liabilities and--where this is prescribed under subsection (7) sentence 4 below--non-nettable add-ons shall be derived from the risk-enhancing elements of interest-rate contract positions and subsequently aggregated over the periods. The interest-rate contract positions shall be calculated in the risk-recording system as the balance of all the asset and liability components of interest-rate futures contracts and option-writer positions under interest-rate option contracts that are attributable to the same period; the bank's own interest-rate option rights, which are to be recorded separately-classified by asset options and liability options - shall be included in the calculation of the interest-rate contract position in the various periods to the extent of the differences (to be determined separately in each case) between the asset components and the liability components of each overall option contract, where their volume, as ascertained in accordance with the first half of this sentence, is reduced by netting against either of these differences. Interest-rate futures contracts and interest-rate option contracts for the purpose of immediately hedging individual fixed-interest-rate items within the meaning of subsection (7) sentence 2 below which have been entered into after the key date of the last fixed-interest-rate table to be compiled, shall be left out of account in the calculation of the interest-rate contract position until the compilation of the ensuing fixed-interest-rate table, provided that the express purpose of hedging was documented at the time they were entered into. In line with their interest-based mode of operation, the interest-rate futures contracts and interest-rate option contracts to be included in the calculation of the interest-rate contract positions shall be taken into account with all their asset and liability components on the assumption of actual settlement. In the risk-recording system, each asset and liability component shall be attributed to those periods which precede the period in which it matures; components which mature in a calendar year subsequent to the long-term coverage span within the meaning of subsection (5) sentence 2 paragraph 4 above shall be attributed to all periods of the recording system.

(7) In every period of the risk-recording system, the risk-enhancing element of an interest-rate contract position as calculated in accordance with subsection (6) above consists of the difference by which the absolute amount of the overall interest-rate position (composed of the combined interest-rate contract position and open fixed-interest-rate position) exceeds the absolute amount of the open fixed-interest-rate contract position, the risk-enhancing element constitutes and asset or a liability. The open fixed-interest-rate positions are determined in each case by the balance of the nominal values of all the on-balance-sheet and off-balance-sheet fixed-interest-rate items (other than the components of the interest-rate contracts specified in subsection (6) sentence 2 above) attributable to the same period; they are to be obtained from the latest of the fixed-interest-rate tables which the bank must compile within one month by a consistent method at least as at the end of each calendar quarter, in line with the division by periods of the risk-recording system. In the fixed-interest-rate table, each fixed-interest-rate item shall be attributed to those periods which precede the period in which the fixing of its interest rate comes to an end. In order to determine the risk ratios which are to be found in the periods of all coverage spans and the add-ons which have to be taken into account as well in the first three calendar quarters of the short-term coverage span, the risk-enhancing
elements within the meaning of sentence 1 above shall be weighted with period-related percentages; these percentages are:

1. if the risk ratios are derived for each calendar quarter for each period of one year 0.5% 2.0%
2. if the add-ons are derived for each calendar quarter 0.5%

In each of the coverage spans as defined in subsection (5) sentence 2 paragraphs 2 to 4 above the risk coefficient is formed by the absolute amount of the balance of the asset-side and liability-side risk ratios of the pertinent periods, and in the coverage span as defined in subsection (5) sentence 2 paragraph 1 above it is formed by the sum of the absolute values of this balance and of the add-ons in accordance with sentence 4 above.

(8) The difference for determining the risk position as defined in subsection (2) sentence 1 paragraph 3 above shall be calculated separately for each type of instrument involving a price risk underlying the futures and option contracts; in each case they are formed by the absolute amount of the balance computed from the bank’s delivery rights and delivery obligations under option contracts (on the assumption of actual settlement) arising from all futures contracts and option-writer positions, provided that these contracts do not hedge the price risk involved in a portfolio of similar instruments. The Bank’s own option rights are included in the balance to the extent of its aggregate delivery rights under call options and its aggregate delivery obligations under put options, provided that netting against either of these aggregates reduces the size of the balance as ascertained in accordance with the second half of sentence 1 above.

(9) The asset and liability components of option contracts shall be included in the calculation of risk positions as defined in subsection (2) sentence 1 above to the extent of the minimum percentages prescribed under sentence 5 below or of higher ratios deriving from a computer-assisted option price model consistently used by the bank. The minimum percentages are determined by the value of the coverage coefficient which is to be calculated for each option contract at the close of business every day. The coverage coefficient (cc) shall be calculated.

(1) In the case of contracts

(a) involving call options included in the risk positions as defined in subsection (2) sentence 1 paragraph 1 or 3 above, and

(b) involving asset-side interest rate options included in sentence 1 paragraph 2 above,

by the formula

\[ CC = \frac{FR - SP}{SP} \times \frac{360}{RM} \]
(2) In the case of contracts

(a) involving put options included in the risk positions as defined in subsection (2) sentence 1 paragraph 1 or 3 above, and

(b) involving liability-side interest-rate options included in the risk position as defined in subsection (2) sentence 1 paragraph 2 above,

by the formula

\[ CC = \frac{SP - FR}{SP} . \frac{360}{RM} \]

where “FR” = the Futures Rate applying to the underlying instrument,
“SP” = the agreed Strike Price, and
“RM” = the Residual Maturity of the option in days.

Where the residual maturity is less than thirty days, the number “30” shall be inserted in place of “RM”. The minimum percentage is as follows:

- for coverage coefficients of less than -0.02: 0%
- from -0.02 to less than ±: 20%
- from ±0 to less than +0.08: 50%
- from +0.08 to less than +0.14: 70%
- of ±0.14
GENERAL ANNEX 1
BASIC ELEMENTS OF RECENT FINANCING PACKAGES

1. Basic Elements of the 1990 Mexico Financing Package

(a) Collateralized Floating Rate Discount Bond Exchange. Under this option creditors could exchange their original loans for new collateralized floating rate discount bonds issued by the United Mexican States in a principal amount equal to 65% of the principal amount of the eligible debt offered for exchange. The new bonds were registered in form, with the exception of some bonds issued to German banks. All bonds will mature in a single installment on December 31, 2019 and bear interest at a rate of 13/16% per annum over the six-month LIBOR rate for the currency in which the bonds are issued. Payment of the principal in 2019 is secured by zero-coupon U.S. Treasury obligations (or other comparable collateral for non-U.S. dollar obligations). Payment of interest is secured by a pledge by Mexico of cash or permitted investments in the currency of the bonds in an amount equal to eighteen months interest at an assumed LIBOR of 10% for US dollars.

(b) Collateralized Fixed Rate Par Bond Exchange. Under this option creditors could exchange their eligible debt for Collateralized Fixed Rate Par Bonds issued by the United Mexican States in a principal amount equal to 100% of the principal amount of the eligible debt offered for exchange. The fixed rate bonds are also registered in form with the exception of the bearer bonds issued to German banks. The bonds mature in a single installment in 2019 as in the case of the Discount Bonds above. The Par Bonds carry a sub-market rate of interest equal to 6.25% for the bond denominated in U.S. dollars and corresponding rates for those issued in other currencies. These are collateralized in the same fashion as the Discount Bonds, except that interest coverage is exactly eighteen months of the contracted coupon.

(c) New Money Credit Arrangement. Under this option, creditors could provide Mexico with new money loans. The loans had a fifteen year term (including 7 years of grace) and an interest rate of a) 13/16% over LIBOR, b) 13/16% over the three months Certificate of Deposit rate or c) a fixed rate calculated to provide a comparable yield to maturity as the floating rate option.

(d) New Money Bonds. Under this option, creditors could elect to purchase New Money bonds in an amount up to 50% of their New Money Commitment. There was, however, a ceiling of $500 million on the total amount of New Money bonds issued. New Money bonds were issued by the United Mexican States in registered form in US dollars and carried an interest rate of 13/16% over LIBOR. The bonds are repayable in equal semi-annual installments beginning in 1997 and ending in 2004 (i.e. 15 year maturity including 7 years of grace).

(e) Onlending Facility. Creditors can elect to make advances, up to a limit of 20% of their New Money Commitment, to a trust established by Mexico (with Banco de Mexico as trustee) for the purpose of onlending funds to Mexican public sector borrowers with the guarantee of the United Mexican
States. These advances will have the same repayment schedule as the loans made under the New Money Credit option (i.e. 15 year maturity including 7 years of grace), at an interest rate of (a) 13/16% over LIBOR, or (b) 13/16% over the three month Certificate of Deposit rate. Advances made under the Onlending Facility may be in any of the currencies permitted under the New Money Credit Agreement.

(f) Medium-Term Trade Credit Facility. Creditors can elect to make advances, up to a limit of 20% of their New Money Commitment, to a trust established by Mexico (with Banco de Mexico as trustee) for the purpose of financing certain eligible trade credits (e.g. unguaranteed portions of bilateral trade credits to Mexican private sector borrowers for transactions approved by Mexico). The Medium-Term Trade Credit Facility will have the same primary terms and conditions as the Onlending Facility.

(g) Other Features:

(i) Banks included in the exchange are able to participate in a debt/equity program which is authorized for a maximum of US$ 1 billion per annum, and also restricted to privatizations of public sector companies.

(ii) The Par bonds and Discount bonds also included value enhancement facilities (warrants) which entitle holders to payments tied to the price of oil after July 1, 1996. Should the annual average price exceed US$ 14 per barrel, holders are entitled to 30% of the additional oil revenues accruing to Mexico. In a given year the total amount shall not exceed 3% of the face value of the debt held, however.

2. Basic Elements of the 1990 Philippines Financing Package

(a) New Money. Creditors could provide new money in the form of bonds or loans, with a 15 year maturity, including 8 years of grace, and an interest rate of 13/16 of 1% over LIBOR. Bank participation in new money was voluntary. The Philippine authorities had indicated that $1 billion over two years would be desirable, only about $715 million was secured.

(b) Buyback. The Central Bank of the Philippines offered to purchase up to $1.3 billion of certain categories of commercial bank debt at a 50% discount. The buyback was greatly oversubscribed as nearly $1.8 billion in loans were offered for purchase; however, due to paucity of resources to fund the buyback only $ 1.3 billion as planned was purchased.

(c) Other Features.

(i) a restructuring of the debt covered by the 1985 New Money Agreement on the same terms as the 1989 bonds. As of March 31, 1989 this amounted to $780 million, $200 million of which was scheduled to mature in 1990;

(ii) amendments to each Public Sector Restructuring Agreement which, among other things, reduced the interest spread on these loans from
14/16% to 13/16% over LIBOR to conform to the 1989 New Money Bonds and Loans; and

(iii) up to 20% of a bank's new money contribution could take the form of a relending facility. Half of such relending could go to the private sector, and half to the public sector.

In addition, existing agreements between the Philippines and the commercial bank were amended to permit the Philippines to use up to $1.5 billion directly and indirectly derived from official sources for cash buybacks or for credit support of debt exchanges for discount or par bonds. The country is also permitted to use up to $300 million a year from any source for such purposes in certain circumstances. This allows the Philippines to undertake additional debt and debt service reduction operations in the future. In addition, the Philippines is permitted to pledge up to $200 million a year of assets, revenues, or receivables for new money borrowings.

3. Basic Elements of the 1990 Costa Rican Financing Package

(a) Cash Buy-Back. Each creditor bank could offer its outstanding claims including interest arrears for purchase at 16 cents on the dollar.

(b) Series A Par Bonds. Banks offering 60% or more of their claims for cash buyback were offered Par bonds for the balance of their claims. These bonds have a fixed interest rate of 6.25% per annum, with a final maturity of 20 years and a grace period of 10 years 18 months of interest payments on these bonds were collateralized by funds provided by a wide variety of bilateral donors and lenders.

(c) Series B Par Bonds. Banks offering less than 60% of their claims for cash buyback were permitted to exchange the balance of their claims for Par bonds with an interest rate of 6.25% per annum, a maturity of 25 years including a grace period of 15 years. The interest payments on these bonds were not collateralized.

(d) Interest Capitalization. The past due interest associated with debt not repurchased in the buyback was repaid on the following basis: (i) 20% paid as a down payment; and (ii) the remaining 80% will be repaid over a 15-year period at a rate of LIBOR + 13/16 of 1%. A collateral of 36 months of interest payments on the bonds was provided for banks that tendered 60% or more of their claims for the cash buyback. Banks that did not tender over 60% of their claims received interest bonds of similar features, although no collateralization was available.

(e) Recapture Clause. The Par bonds included a recapture clause under which the rate of interest on the bonds and/or the rate of payment on the PDI facility would increase if Costa Rica's GDP exceeds 120% of the 1989 level in real terms, according to a specific formula.

(f) Debt Conversion Program. Costa Rica will implement a $100 million, 5-year debt conversion program with a minimum amount of $20 million in transfer value each year. The bonds and interest claims will be eligible for such conversion.

(g) No new money. No new money was sought from the commercial banks.
4. Basic Elements of the 1990 Venezuela Financing Package

(a) **New Money Bonds**: Creditor banks could provide new money through bonds with 15 year maturity including 7 years of grace. There are two series of bonds -- Series A (issued by The Republic of Venezuela) carry an interest rate of 1% over LIBOR and Series B (issued by The Central Bank) maintain a rate of 7/8% over LIBOR. For each $1 committed to the new money bonds, a creditor is entitled to exchange up to $5 of old debt at par for debt conversion bonds. The debt conversion bonds would have a 17-year maturity including 7 years of grace and an interest rate of 7/8% over LIBOR. The new money and debt conversion bonds do not carry any credit enhancement on interest or principal.

(b) **Front-loaded Interest Reduction Bonds (FLIRBS)**: On these US dollar bonds, the interest rate in the first two years is 5%; in the third and fourth years, 6%; and in the fifth year, 7%. For the remaining life of these bonds, the interest rate will be 7/8% over LIBOR. The bonds have a 7-year grace period and a 17 year final maturity and have been exchanged for old debt at par. An escrow account to cover interest payments for 12 months over the 5 years of reduced interest rates has been provided. There is no collateralization of principal.

(c) **Collateralized Floating Rate Discount Bond Exchange**. Under this option creditors exchange their original loans for new collateralized floating rate discount bonds issued by the Government of Venezuela in a principal amount equal to 70% of the principal amount of the eligible debt offered for exchange. The new bonds were registered in form, with the exception of some bonds issued to German banks. The bonds have a bullet maturity of 30 years and bear interest at a rate of 13/16% per annum over the six-month LIBOR rate for the currency in which the bonds are issued. The principal would be secured by 30-year zero-coupon bonds. Payment of 14 months of interest is secured through escrow arrangements.

(d) **Collateralized Fixed Rate Par Bond Exchange**. Under this option creditors exchange their eligible debt for Collateralized Fixed Rate Par Bonds issued by the Government of Venezuela in a principal amount equal to 100% of the principal amount of the eligible debt offered for exchange. The bonds have a bullet maturity of 30 years and carry a sub-market fixed rate of interest equal to 6.75% (for the bond denominated in U.S. dollars).

(e) **Collateralized Short Term Notes**: The Notes, denominated in US dollars, have a maturity of 91 days. They have an aggregate face value equal to the sum of (a) 45% of the aggregate principal amount of the Eligible Debt for which they are exchanged (the "Discounted Amount") and (b) an amount equal to interest on the Discounted Amount for a period of 91 days at a rate per annum equal to the coupon equivalent yield for the 13-week US Treasury bills prevailing just prior to the exchange. The Notes were fully collateralized by a pledge of US Treasury obligations and were be issued in registered, global form. The Government of Venezuela offered to exchange up to $5.5 billion of existing loans for the Notes, and if the option is oversubscribed, each bank's offer will be accepted on a pro rata basis.
(f) **Other Features:** Both Par and Discount bonds carry detachable oil warrants. These entitle the holder to receive a payment when the real price of oil exceeds US$ 26 per barrel in the sixth year or beyond, subject to a ceiling of 3% of the amount of debt exchanged.

5. **Basic Elements of the 1991 Uruguay Financing Package**

(a) **Cash Buy-Back.** Each creditor bank was able to offer its outstanding claims for purchase at 56 cents on the dollar.

(b) **Par Bonds.** Those who opted for Par bonds exchanged their claims at 100% for registered bonds carrying a fixed interest rate of 6.75%. Unlike other instruments these have no grace period, however they do carry a 30 year maturity and have the principal collateralized by 30 US treasury bonds. Interest is collateralized with an 18 month rolling escrow account.

(c) **New Money and Conversion Bonds.** US$ 89 million is entitled to be disbursed in two separate tranches. The New Money Bonds carry an interest rate of LIBOR + 1% and have a 15 year maturity with 7 year grace. Each dollar disbursed entitles the lender to five dollars (face value) of conversion instruments which have neither principal nor interest collateralization, and carry an interest rate of LIBOR + 7/8%. The conversion instruments have a 17 year maturity and 7 year grace.

(f) **Other Features:** The Par Bonds carry a value recovery clause which entitle holders to payments based on a terms of trade index. The index includes prices of wool, rice, and beef (exports) and oil (imports).
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The World Bank
Headquarters
1818 H Street, N.W.
Washington, D.C. 20433, U.S.A.

Telephone: (202) 477-1234
Facsimile: (202) 477-6391
Telex: WUI 64145 WORLD BANK
Cable Address: INTRAIRAD WASHINGTON DC

European Office
66, avenue d'Iéna
75116 Paris, France

Telephone: (1) 40.69.30.00
Facsimile: (1) 40.69.30.66
Telex: 640651

Tokyo Office
Kokusai Building
1-1 Marunouchi 3-chome
Chiyoda-ku, Tokyo 100, Japan

Telephone: (3) 3214-5001
Facsimile: (3) 3214-3657
Telex: 26838

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