ESSAYS IN INTERNATIONAL FINANCE

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1 Introduction

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

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

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

¹ The official sector did respond in some ways. For example, the International Monetary Fund established an Oil Facility to assist the countries that were most hurt by the oil price rise.
Peru announced that it would limit its payments of principal and interest to a maximum of 10 percent of the country's export earnings.

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

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

2 The Factual and Statistical Background of Provisioning

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

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

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

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

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

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

\(^2\) Most provisioning by commercial banks has been presented publicly as being against a group of, say, thirty-five countries. Actually, the banks arrive at the overall provision by aggregating notional provisions against individual countries.
suggests that there may be quite wide divergences. Thus, for a bank with an overall provision of, say, 25 percent, the reserve against one Latin American country may be as low as 5 percent, while that against another may be as high as 35 percent.\(^3\)

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

\(^3\) These figures are derived from data on the practices of Dutch banks in 1986, as reported to IBCA Banking Analysis, but similar divergences seem to exist among other banks.
To some extent, the varying levels of provisioning may reflect the traditionally different attitudes of bankers throughout the world to the optimum point of any return/risk tradeoff. German bankers, for example, frequently criticize the rapid expansion of U.S. bank loans to developing countries during the 1970s precisely because of the risks involved and because of their own more prudent approach to lending.

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

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

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

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

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

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

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

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

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

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

While this discussion describes the effects of the additional provisioning on the balance sheets of the banks, it is also important to examine the timing
### TABLE 2

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

*(dollar figures in millions)*

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

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

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

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

d Reserve increase announced after this table was completed.

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

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

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

3 Factors Influencing Provisioning

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

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

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

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

Against this analytical background, the remainder of this section distinguishes between environmental factors—broad secular influences that created an environment in which provisioning was more likely to occur, and bank-specific factors— influences that may provide more immediate explanations of why the banks provisioned when they did. After identifying a number of factors that may have affected the decisions of banks to set aside extra loan-loss reserves, we take a brief look at two specific cases: (a) Citibank, which added to its reserves on May 19, 1987. After a lapse of one week, Norwest and Chase Manhattan followed suit. Then, during little more than the first two weeks of June, another fifteen major U.S. banks responded by raising their provisions. A similar lagged response was seen in other parts of the world: the U.K. banks began to set aside extra provisions in mid-June.
bank's decision to add $3 billion to its loan-loss reserves on May 19, 1987, and the related decisions of other U.S. money-center banks and (b) National Westminster Bank's decision to add £466 million to its sovereign debt provisions on June 16, 1987 and, again, the related decisions of the other U.K. clearing banks.

Environmental Factors

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

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

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

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

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

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

The hope that these policies together would solve, or at least alleviate, the debt problem has not been realized. Indeed, some banks view the approach as growing less successful as time has gone on. They perceive a “weakening” of IMF conditionality in recent years. Provisioning represents a response by the banks to their frustration over the inability of the international economic system as a whole to resolve the debt problem. No longer believing that the problem will be resolved within a reasonable time span, the banks are using provisioning to legitimize the situation as it is. Provi-
sioning reflects the gradual change of mood among bankers from guarded optimism to pessimism with respect to the prospects for solving the third-world debt problem.

The world macroeconomic outlook. The discussion above suggests that provisioning will be affected by the past and present performance of the debtor countries, but in fact the banks are taking past performance as an indicator of future performance. It is future economic performance, after all, that will affect the countries' ability to service their debts. And that performance will of course depend on the performance of the industrialized economies of the world. Various models and estimates have been made of the degree of interdependence between the developing and industrialized worlds, and opinions vary on its significance. But, at the least, an industrialized-country scenario of falling rates of economic growth, rising rates of interest, and increasing protection would warn of the difficulties to be faced by debtor countries in their efforts to expand their export earnings and increase their debt-service payments. In these circumstances, the banks would again perceive an increase in the risk attached to a given portfolio of loans to developing countries and would be encouraged to increase their provisions against such loans. A pessimistic global economic outlook might make other bank assets look riskier as well, but developing-country loans are particularly vulnerable to the economic variables mentioned.

In the first half of 1987, bankers perceived a low-growth world economy, largely on the basis of projections from international and official agencies. It follows that their loans to developing countries began to look riskier to them.

The tax and regulatory environment. Early reports in the media suggested that Citibank's decision to add to its provisions could be explained largely in terms of certain unspecified tax advantages. Moreover, as noted in section 2, banks in countries where the tax and regulatory environment has been more supportive of provisioning, like Germany, have conventionally held somewhat higher provisions. It may nevertheless be unwise to conclude that there is a strong causal link between provisioning and the tax and regulatory environment. Prior to the change in federal tax law in 1986, for example, U.S. regulations were more liberal than those of the United Kingdom, and yet U.S. banks did not hold proportionately higher reserves. In this case, the reluctance of U.S. banks to add to their reserves almost certainly reflected their high exposure, but the example does serve to show that the tax and regulatory environment may not be a dominant factor.

This is confirmed when an intertemporal rather than cross-sectional approach is adopted. Concentrating again on the United States, the 1986 changes in the tax treatment of provisions should have made it less attractive to add to loan-loss reserves. Yet it was in the following year that the
U.S. money-center banks made the principal increases. Discussions with both Citibank and the U.S. Treasury confirm that the media reports of the influence of tax considerations on Citibank's decision were entirely without foundation. Indeed, Citibank held meetings with the Treasury after the bank's announcement of extra reserving in order to clarify the tax position, largely because of the confusion caused by these press reports. Similarly, the U.K. clearing banks decided to increase provisions even though the tax treatment had not yet been agreed upon. Again, the most formal statement about provisioning by the U.K. regulatory authorities was made after the additional reserves had been set aside. Those involved in the provisioning exercise do not ascribe an important role to tax and regulatory factors in explaining intertemporal changes in the extent of provisioning. Yet even though these factors have not been important in the past, they may be important in the future. It is difficult to believe that a more interventionist approach by the regulators or a clearer and more cohesive statement of the tax treatment of provisioning would be inconsequential.

Finally, it is possible that provisioning will have an effect on the tax and regulatory environment rather than the reverse. The banks may increase provisioning in an attempt to put pressure on the tax authorities to make concessions, or to forestall the imposition of formal regulations mandating reserves against specific countries.

Market valuation. The behavior of the banks may best be explained by applying the traditional theory of the firm, under which banks set out to maximize profits. But banks are also concerned about their market valuation, as reflected by their share prices, since it affects their ability to fend off potential takeovers or to acquire competitors. Thus they are sensitive to the ratings they receive from bank analysts.

Prior to the wave of extra provisioning begun by Citibank, banks were under market pressure to acknowledge the weakness of many of their developing-country loans. The pressure took various forms: a share price that was discounted in proportion to the individual bank's exposure in particular countries; the discount on the secondary-market value of developing-country debt; and, connected with these phenomena, somewhat gloomy reports by market analysts on the banking sector in general and the relatively highly exposed banks in particular. The market had discounted developing-country debt in advance of the banks, and bank provisioning can be seen as a response to and recognition of this judgment.

It is therefore not coincidental that, as banks provisioned, their share prices tended to rise (although this effect was temporary). Normally, one would expect share price and profitability to be positively related; in this case, the market was apparently welcoming what it saw as a more realistic approach by the banks. The fact that the banks had formally come to accept
the risks associated with their developing-country loans raised market confidence.

Furthermore, it was partly through the market mechanism that actions by key debtor nations impacted on the banks' provisioning decisions. Peru's limitation of debt servicing may have had relatively little effect on the market's mood, but Brazil's suspension of interest payments had a strong impact. Through this indirect route, if not through more direct routes to be outlined below, Brazil's actions help explain why the banks took the decisions they did at the time they did.

**Bank-Specific Factors**

*Changing methods of risk assessment.* The literature is rife with suggestions that during the 1970s the banks' techniques for assessing risk were not very scientific, but their methods may have improved since then (see, e.g., Bird, 1986). Loans are continually being reassessed, so it might be expected that changing techniques would lead to changing perceptions of risk. That would explain why developing-country loans have gradually come to be regarded as more risky by the banks that made them. It would appear, however, that modifications in country-risk analysis are not an important factor, because the traditional methods of risk analysis would also be suggesting increased risk. Furthermore, events since 1982 have made the banks more averse to risk than they were before.

*Internal adjustment within the banks.* In the literature, the emphasis is usually on the need for adjustment by debtor countries as a result of their acquisition of debt and its related obligations. While this need cannot be denied, it is also true that developing-country debt has brought about a need for adjustment by the banks that made the loans. For some time, banks have been engaged in this process of adjustment by strengthening their capital bases and looking for new and more secure lines of business. Although some banks have pursued this process more successfully than others, the trend has been fairly general. As a result, banks apparently now feel strong enough to shoulder the cost of provisioning.

Growth in other lines of business is unlikely to be the only component of the banks' internal adjustment. While they are without doubt eager to take some of their developing-country loans off their books, that is hard to do when the loans are carried at full face value on their balance sheets but are discounted in the secondary market. Provisioning, which essentially recognizes the market valuation, gives the banks much more flexibility in managing their portfolio of loans and can be seen as another necessary component in the banks' strategy for handling their developing-country exposure.

*The competitive process and bank strategy.* It must be remembered that banks are in competition with one another. Whatever market segmentation
exists is not sufficiently pronounced to give banks effective areas of monopoly. The structure of the banking industry in most countries makes it possible for large banks to identify their principal competitors, and they compete by means of weapons involving both the range and the prices of the services they offer their customers. They also compete by means of marketing and advertising. In view of the importance of competition among the banks, we can assume that a decision made by one bank will take into account its effects on competitor banks, and, in turn, their likely responses.

In such a market environment, firms will be inclined to take actions they deem to be relatively advantageous. Even a move that hurts short-run earnings and profits may be attractive if it forces competitors to follow suit with still more damaging effects for them, because the initiating firm will improve its relative position in the industry. Provisioning is such a move; it affects earnings, profits, and share prices. Thus its implications for a bank’s competitive position in the industry are likely to influence the decision.

The importance of this factor depends on how wide the differences are among banks in their ability to set aside provisions and on how aggressively competitive the relatively stronger banks are. In a highly competitive environment, possibly with excess capacity in the banking industry, a decision by one bank to raise its provisions might even be viewed as a predatory policy akin to the practice of predatory pricing in other industries.6

The more profitable a bank is and the greater its ability to foster and develop other lines of business, the more inclined it will be to set aside relatively large provisions. In general, the banks with the smallest exposures in developing countries will be inclined to set aside the largest proportionate provisions against these loans. In addition, some banks may be in a better position to exploit the opportunity for debt-equity swaps, which, as we see later, are facilitated by provisioning. A bank with a relatively wide network of branches and with good information about investment opportunities in developing countries may be more enthusiastic about such swaps and therefore more eager to prepare the ground for them than other banks.

The politics of decisionmaking. Not only financial and economic factors affect decisions made by banks. Banks are bureaucratic structures, and decisions will reflect managerial goals. Changing managerial regimes within any firm may cause a shift in policy. An incoming chairman may, for example, wish to distance himself (or herself) from decisions made by a predecessor and to impose a new personality and authority. An outgoing chairman may wish to secure the company’s position before departing in order to avoid the personal risk of being blamed later for ill-founded decisions.

6 Some commentators have identified a new era of entrepreneurial competitive spirit. Similarly, and graphically, the Chairman of Citibank, John Reed, has been described by a fellow banker as the “Rambo of the money-center banks.”
While it is difficult to model these factors and treat them rigorously, those who have worked in large organizations recognize that personalities and internal organizational politics are often important influences on decision-making. It would therefore be unwise to ignore them when trying to explain commercial-bank provisioning.

*The games theory of debtor-creditor relations.* Provisioning by the banks has not been an isolated action. It represents one component in an ongoing set of negotiations and relationships between debtor countries and creditor banks. The debtors wish to minimize their servicing obligations without damaging their future access to markets, and the banks wish to maximize receipts, perhaps by agreeing to terms that are not so stringent as to encourage debtors to opt for all-out default. In such negotiations, the participants will constantly be “positioning” and trying to send each other “signals” designed to strengthen their own bargaining stance. A new position adopted by one side will induce a change in the position adopted by the other side (for a fuller analysis of the bargaining positions of creditors and debtors, see Cohen, 1988).

In this context, the banks’ decisions to increase their provisioning against claims on developing countries can be interpreted as a signal to debtors in advance of forthcoming negotiations. It might be initiated by the banks, or it might represent a response to a perceived change of position by a particular debtor or group of debtors. But the signal transmitted by increased provisioning is ambiguous. From one point of view, it can be seen as a softening of the banks’ position, since it implies recognition by the banks that they are unlikely to receive full payment on their developing-country loans. The whole rationale of provisioning is associated with such increased risk. From this angle, increased provisioning signals that the banks are now in a better position, and are more willing, to make concessions to the debtors.

Bankers vigorously deny that this is the signal they are sending via provisioning. Indeed, they downplay the entire game-theoretic approach. If provisioning means anything, they argue, it suggests that the banks will adopt a “tougher” or “more realistic” position vis-à-vis borrowers in rescheduling negotiations. The logic here seems to involve two points: First, the banks are now in a better position to “take a hit” on their LDC loans. And, second, since provisions are now being set aside against such loans, it is going to be more difficult for debtor countries to attract new money from the banks.

While there is some truth in the second point, which is examined more fully in section 4, the first point is questionable. The demonstration by the banks that they are in a stronger position to withstand a “hit” may actually make it *more* likely that they will have to sustain one. Bankers’ statements that provisioning does not represent a softer position and may indeed represent a harder one would seem to be designed merely to limit the damage
to their bargaining position. The banks' chances of being fully repaid are not enhanced by evidence that they admit its improbability.

This uncertainty about the debtors' interpretation of bank provisioning makes it difficult to believe that the increase in provisioning in mid-1987 was purely a bargaining response to the Brazilian decision to suspend interest payments early in 1987.\footnote{Subsequently, in December 1987, Brazil agreed with its Bank Advisory Committee to correct its interest-rate arrears under an arrangement that sees the banks disbursing $3 billion to Brazil and Brazil paying creditor banks $4.5 billion in interest payments.}

Of course, banks will be concerned not only about how their decisions are interpreted by the debtor countries but also about what they communicate to the official sector. The banks feel that excessive pressure has been put on them to provide new money in recent negotiations—in particular those involving Mexico—and see themselves as often assuming the role of lender of last resort. Thus they were pleased to send a message, via provisioning, that new money would be less available in the future, and thereby to put more pressure on the official sector. This was especially so because the banks have been critical of certain elements of the official sector, notably the Paris Club, the export-guarantee agencies, and, latterly, the IMF.

Although this discussion has lumped all the banks together, there may be slight, but still important, differences among banks in the signals they wish to send to individual debtor countries. A bank with a relatively large exposure in a particular country may be inclined to adopt a different approach from a bank with a smaller exposure.

Assigning Relative Importance

Having identified some factors that may have an influence on commercial-bank provisioning against developing-country loans, we must now assign them relative importance in explaining the spate of additional commercial-bank provisioning that occurred in mid-1987.

Stated most extremely, if the economic and debt positions of the highly indebted countries had not deteriorated, there would have been no need for banks to provision. Yet the deterioration was gradual and does not explain the timing of provisioning.

The extra loan-loss reserves set aside by the U.S. money-center banks were a response to the lead set by Citibank. The other banks provisioned largely to defend their market positions. Most representatives of such banks suggest that they would not have set aside extra provisions had it not been for the Citibank move. The question then is why Citibank decided to increase its provisions. Some guidance is provided by Citibank's own account, which emphasizes market pressures and the desire to strengthen
its balance sheet in order to gain more flexibility in its operations and to pursue debt-equity swaps. We can assume, however, that Citibank would not necessarily tell the whole story. The consensus among competitors and commentators is that there were other important factors.

First, there was the desire to gain a competitive advantage over other U.S. money-center banks. The Citibank announcement was carefully orchestrated and well marketed, and it undoubtedly embarrassed some of the other banks. In absolute terms, Citibank was more heavily exposed in developing countries at the end of 1986 than any of the other U.S. money-center banks, but its exposure-to-equity ratio was well below that of Bank of America and Manufacturers Hanover. However, its exposure-to-equity ratio was similar to that of Chase Manhattan and Chemical Bank, somewhat above that of Bankers Trust, and well above that of the others. Citibank was therefore not in a uniformly stronger position to set aside provisions, but it was in a stronger position than its closest competitors, particularly given its aggressive attitude toward debt-equity swaps.

Second, there was the personality of the recently appointed Citibank chairman, which suggests to some observers that internal bank politics, as described earlier, were an important factor.

Of much less importance because of its ambiguity was Citibank’s desire to send a coded message to debtors, and to Brazil in particular. Nor, apparently, was the tax position important, in spite of suggestions in early press reports that tax advantages lay at the heart of the decision. Similarly, the regulatory environment was apparently of little relevance, except to the extent that Citibank was anxious to forestall moves that would tighten regulations by requiring greater specific provisioning. 8

A similar story emerges from an examination of the additional provisioning undertaken by the clearing banks in the United Kingdom. Here again the process was led by the bank regarded as perhaps the most aggressively competitive, the National Westminster Bank. Moreover, Nat West, with relatively low loan exposures in developing countries, was in the strongest position to provision against such loans. As with the Citibank move, Nat West’s additional provisioning strengthened its market position, inducing the other clearing banks to take similar measures. The regulatory environment and the tax position in the United Kingdom with respect to provisioning do not seem to have had a significant impact here either. Although U.K. banks had been encouraged by bank regulators—essentially the Bank of England—to review the adequacy of their provisions, the tax treatment of provisioning was undefined at the time Nat West made its deci-

8 For an alternative analysis of the Citibank move that came to my attention too late to be fully integrated into this essay, see Guttentag and Herring (1989).
sion. Discussions with Nat West representatives also suggest that game-theoretic explanations did not have an important part to play. Instead, the feeling was that Citibank's move had altered the "market environment" and that it was therefore an appropriate time for Nat West to bring greater realism to its accounts. Nat West had a less well-articulated internal bank strategy for handling its exposure than did Citibank.

This review of the causes of provisioning points to a combination of general environmental factors and narrower, more bank-specific, factors. The overall performance of debtor countries in the mid-1980s and beyond provided little hope of short-run improvement in their ability to service their debts. The financial markets made this assessment, and it was reinforced by greater difficulties in rescheduling and by unilateral decisions of key debtors to limit their debt payments. As a result, the market discounted its valuation of the banks' loans to developing countries. Provisioning represented a response to this deteriorating situation, but it was also used in a competitive way. There was no uniform approach in the banking industry, but rather one of action and counteraction. Banks have been anxious to avoid damaging their negotiating positions when they add to provisions, but it is doubtful that the primary motive behind provisioning was to send a positioning signal to debtors. Although variations in regulatory and tax environments help to explain why banks in different countries have provisioned to different extents, changes in these environments do not seem to have had any discernible impact on provisioning over time. To the extent that provisioning decisions reflected internal bank politics, explanations can be sought more appropriately in managerial theories of the firm than in the simple theory of profit maximization.

4 Implications of Provisioning

It has been argued that the implications of increased provisioning are likely to be marginal, since it is essentially an accounting adjustment that acknowledges and formalizes pre-existing weakness in the banks' balance sheets. Although there would appear to be considerable truth in this view, it is possible to examine the potential implications of provisioning more thoroughly and systematically.

The question is approached here by looking at the implications of increased provisions for the various actors involved in the international debt problem: the banks, the indebted countries, and the official sector. The implications of provisioning for interactions among these actors are also briefly examined.

For the Banks

Provisioning brings the banks' balance sheets more in line with market per-
ceptions. Any discrepancy between the market view, as indicated by analysts' reports and the banks' stock prices, and the banks' view, as indicated by their published balance sheets, will be a cause of concern in the market and will lower confidence in the banks. Removal of the discrepancy will help restore confidence. Bankers clearly anticipated that provisioning would improve the banks' market position, and evidence confirms its positive short-run effect on bank stock prices. It also suggests that the earlier provisioners enjoyed the greatest stock-price increase.

However, it was always doubtful how durable this improvement would be. After all, provisioning does nothing to strengthen the basic position of banks that have suspect LDC loans on their books. Nor does it really raise the probability that debtors will be able to service their debt obligations, as will be seen below.

The expectation should therefore have been that provisioning would have only a short-run beneficial effect on banks' share prices, but that in the longer term the market valuation of the banks would not increase. For it to increase, the banks would have had to shed some of their LDC loans, expand into new lines of business, or continue to add to provisions. Or, alternatively, the economic performance and prospects of the debtors would have had to improve significantly.

Banks with less exposure in developing countries are likely to be in a stronger market position than those with a heavy concentration of loans, but even unexposed banks may find it difficult to distance themselves completely from the market's judgment of the heavily exposed ones. One reason is that banks' fortunes are connected through the interbank market.

Their eagerness to shed LDC debt has encouraged banks to consider the scope for debt sales and debt-equity swaps. Either one will be fostered by provisioning, which marginalizes the banks' decision to accept a discounted price for developing-country debt.

In the past, the quantity of debt swaps has been constrained by the unwillingness of U.S. banks to accept a reduction in the face value of their developing-country assets. Increasing loan-loss reserves may not be the same as writing down debt, but it does suggest that some debt will have to be written down. For this reason, one constraint on debt conversion is relaxed by provisioning.

How significant this relaxation is depends on how effective the constraint is. Some observers have argued that debt-swap activity is more effectively constrained by the limited range of suitable equity investments in highly indebted countries and by the attitudes of the debtor-country governments to foreign investment. If these are indeed the real constraints, then provisioning is unlikely to have a significant effect on the level of debt swapping.

Even among bankers, there were differences in 1987 about just how important debt swapping would be, though all agreed that provisioning had
the important effect of making their loan portfolios more flexible or "malleable." Some bankers saw debt-equity swaps as integral to their internal strategy. Citibank, for example, made press announcements to this effect when reporting its additional loan-loss reserves. Others saw the potential for debt swaps as small in relation to the size of the debt involved.

In the months after the surge of provisioning in mid-1987, the strategy of the banks was more clearly revealed. There were reports in the media (see New York Times, July 27, 1988) that during the second quarter of 1988 thirteen of the largest banks in the United States sold or swapped about $2.3 billion of their LDC loans, accepting 50 to 85 cents on the dollar, having off-loaded only about $1.4 billion in the first quarter. At the same time, the banks were building up their capital bases. As a result, while their LDC exposure fell from $51.6 billion in June 1987 to $45.7 billion in June 1988, their exposure-to-equity ratio fell from 137 to 101 percent. Some of the larger U.S. regional banks reduced their portfolios of LDC loans by 33 to 50 percent within a year.

The banks' apparently increasing willingness to use provisions to offset losses from selling LDC debt at a discount can be explained in large part by the market reaction it induces. Banks with large LDC loan exposures relative to equity have seen their stocks trading at only 70 to 80 percent of their book value. They may have anticipated that shedding such loans would eliminate the discount and reduce their vulnerability to takeover. Indeed, the banks that were relatively slow to reduce their LDC exposures (Bank of America, Chase Manhattan, Chemical, and Manufacturers Hanover) between 1987 and 1988 tended to be the ones with the largest market discounts on their stock. Market concerns are further illustrated by the fact that the banks that increased their provisions to 50 percent at the end of 1987 enjoyed much greater initial appreciation in their market value than those that did not.

Moreover, the Communiqué of the Interim Committee at the Annual Meetings of the Fund and the World Bank in October 1988 argued that the so-called "menu approach" should be broadened to include voluntary market-based techniques. It encouraged creditor countries to explore whether their tax and regulatory regimes were consistent with this policy. Banks have thereby been put under greater pressure to convert out of LDC debt. Provisioning has made the banks more open to such pressure, and it has also made it harder for them to resist it.

Thus the trend would seem to be toward the further shedding of third-world debt by the banks. Nevertheless, the major banks were reluctant to swap their existing Mexican loans for new bonds issued by Mexico and with principal backed by U.S. Treasury bonds, as part of a plan launched in December 1987 to reduce Mexico's external debt burden. This means that the banks are not prepared to swap LDC debt regardless of the price.
While there is debate about how much impact provisioning has on debt-swap activity, it is generally agreed that, other things remaining constant, provisioning will encourage banks to engage in more debt swapping. (For a more detailed analysis of debt swapping, see Bird, 1988.)

It is also generally agreed that provisioning will make banks less willing to put new money into developing countries (although Guttentag and Herring, 1989, argue that the longer-run effects may be positive). The logic is that if a bank has provisioned against old loans, it will also have to provision against new ones. Provisioning is, in effect, a tax on new LDC loans and can therefore be expected to reduce the supply.

Provisioning will tend to reduce the supply of new bank loans in other ways as well. First, small banks will become even more reluctant to participate in new-money packages, since they see the larger banks as being in a stronger financial position. It is easier now to reject the argument that the involvement of the small banks is required to sustain the larger banks and therefore the stability of financial markets. Second, inasmuch as provisioning has been used, or has been perceived to have been used, by some banks as an aggressive weapon of competition, it will be more difficult to get the necessary agreement among banks to put together new-money packages. However, as the December 1987 Brazilian deal reveals, provisioning does not make new money impossible. There are circumstances in which the banks consider it advantageous to make additional finance available to developing countries.

Even so, banks with relatively large provisions can generally be expected to favor some form of debt relief to developing countries over the injection of new money. In the past, differences in the extent of provisioning were used to explain the different attitudes of U.S. and German banks toward third-world debt: since U.S. banks held relatively low loan-loss reserves, they favored new money over any form of debt relief. For debtors, there is the gloomy prospect that, while extra provisioning may deter the U.S. money-center banks and other international banks from making new money available, it may not result in greater debt relief. Indeed, in their public pronouncements bankers have been adamant that additional provisioning does not imply that the banks are prepared to accept anything less than the full servicing and repayment obligations associated with their LDC loans. They frequently maintain that provisioning is a response to market perceptions of default risk rather than a reflection of their own perceptions.

Of course, such statements should not be accepted unquestioningly. Bankers are unlikely to admit that they do not expect full repayment. They are aware that such prophecies stand a good chance of being self-fulfilling, with debtor countries immediately adopting a tougher stance in debt negotiations. Many bankers, in fact, concede that a degree of debt forgiveness
may be appropriate for some of the smaller debtor countries that they sus-
psect are in intractable economic difficulties. At the same time, they are wor-
ried about offering much easier terms to these countries, fearing that the
large debtor nations will expect to receive terms similar to the most-favored
debtor.

Thus, bankers are saying exactly what they might have been expected to
say, but it is difficult to reconcile actions that prepare the banks for loan
losses with words that say such losses are not expected. On the assumption
that actions speak louder than words, it seems reasonable to conclude that
the banks have accepted the fact that they will be forced to grant some debt
forgiveness. Their words are an attempt to minimize their losses.

While the banks will choose a technique for debt relief that will minimize
the amount of relief they must give, an interesting question is whether this
technique is optimal from the point of view of the debtors or indeed from
that of the international financial system. Does the banks’ chosen route max-
imize the real relief for any given financial cost? In other words, is it an
efficient way of handling the international debt problem? Alternatively, the
banks might opt for a structured, coordinated, and centrally administered
system of debt relief under which policy conditionality was applied to the
debtor nations.

Banks may be forced by circumstances to agree to give some debt relief.
The scenario painted by many bankers is consistent with this conclusion,
though it may not be the conclusion they come to themselves. First, there
is the deteriorating performance of the highly indebted countries. Second,
there is the gloomy global macroeconomic outlook. Third, there is the fact
that meaningful quantities of new money cannot be expected from the
banks. If neither private foreign investment nor the official sector fills the
projected financing gap, the only option left for debtor countries is to reduce
their demand for foreign exchange. And they can do that only by imposing
measures to limit imports or by inducing domestic demand deflation—
unless, that is, they decide to do it by defaulting on their debt obligations.

Banks must recognize and address the issue that, while formalized debt
relief does pose the problem of “moral hazard” even when policy condition-
ality is applied, failure to provide relief may induce outright defaults that
will make their losses even greater. This, of course, is the debtors’ trump
card in their game-theoretic negotiations with the banks.

Although provisioning might have been a step toward granting more debt
relief, the way in which it has been carried out may have damaged the cohe-
siveness of the banks. Coordinated approaches may be more difficult to
implement now. We have seen that some U.S. money-center banks think
Citibank’s decision to add to its loan-loss reserves was, in part at least, a
predatory move designed to embarrass them and give Citibank a competi-
tive advantage. This could damage the cooperative spirit in which debt negotiations have been handled by the banks, at a time when the growing reluctance of the small banks to participate in new loans is likely to place a heavier burden on the large money-center banks. One of the banking community's most frequent criticisms of Citibank's move is precisely that it has disrupted what was formerly a cooperative approach by the banks and that it will make the negotiation of new packages more problematical. At the same time, fragmentation among the banks strengthens the bargaining position of the debtors.

This argument should not be taken too far, however. Banks will always base their decisions on what they perceive to be in their own interest. Although greater provisioning may influence this perception, decisions in any set of debt negotiations are unlikely to be motivated simply by a desire to make life difficult for one particular competitor. Discussions among the banks may become less fraternal, but outcomes will not be very different from those that would have resulted had the decisions to add to loan-loss reserves been made collaboratively.

Bankers clearly feel that the most significant implication of provisioning for them is the extra flexibility it gives them in managing their balance sheets. Increased loan-loss reserves provide the freedom to pursue options that would otherwise be unavailable. Apart from this, they do not see enormous implications.

For the Indebted Countries

Country representatives have pointed out on many occasions that provisioning does nothing to alter their contractual debt-related obligations. Even so, there are channels through which extra commercial-bank provisioning might have consequences for the debtor countries. First, it might alter the negotiating environment by changing the relative strengths of the debtors' and creditors' bargaining positions. Just as the banks are unlikely to publicize any softening of their attitudes, the borrowing countries would not necessarily be expected to reveal their actual evaluation of the effect of provisioning on their bargaining strength. Not surprisingly, therefore, press stories have presented the debtor countries' response to provisioning as fairly neutral. There have been suggestions, however, that, since the banks have essentially written down the value of their LDC loans, developing countries should be required to pay interest only on the reduced real value of the debt.

Second, as already explained, provisioning reduces the probability of new-money flows from the banks to the highly indebted countries. If these flows are not replaced from other sources and if there is no related reduction of debt obligations, provisioning will have increased the size of negative net
transfers. The sign and size of net transfers are important variables in models of debt repudiation: the larger the negative net transfers, the greater the incentive to default. If highly indebted countries do now perceive the benefits of default as exceeding the costs and act accordingly, provisioning, which was intended to adjust the banks' balance sheets to the existing debt situation, could make that situation worse. Extra provisioning, far from being the one-time action that some bankers claim, could possess its own internal dynamics. A deteriorating debt situation brought about by provisioning could result in additional provisioning and a further deterioration in the debt situation.

The third way in which extra commercial-bank provisioning can affect the debtor countries is through its impact on debt-equity swaps. This is not the place to provide a detailed analysis of the potential effects of debt-equity swaps on the “host” country. Clearly, however, such swaps reduce the external debt obligations of the debtor country and may induce additional equity investment. If these benefits outweigh the potential costs associated with exchange-rate and monetary management, debtor countries will derive net benefits from debt-equity swaps, and anything that encourages swaps will be to their advantage. And we have seen that provisioning does weaken one of the former constraints on debt-equity swaps.

Provisioning would be more relevant to debtor countries if it could be interpreted as part of a trend toward greater debt forgiveness by the banks. As yet, however, there is no evidence of such a trend. In these circumstances, provisioning’s adverse effects on new-money flows could easily mean that debtor countries will suffer.

For the Official Sector

A reduced flow of new money from the banks has implications for the official sector as well for debtor countries. It increases the pressure on the World Bank and the IMF to play a larger role both in financing balance-of-payments deficits and in articulating appropriate adjustment strategies through the conditionality that both institutions can bring to bear on debtor nations.

If provisioning exacerbates the debt problem by increasing the incentive for debtors to default, it increases the need for compensating action. Provisioning can be seen as an effort by the commercial banks to extricate themselves from their involvement in developing countries—certainly in the form it has taken over recent years—and it leaves a vacuum to be filled by the multilateral agencies.9

9 For a discussion of how the banks view their future contribution to financing economic development, see Institute of International Finance (1987). The emphasis is on projects and on backing the domestic private sector.
This is a reasonable description of views within the banking community. The unanimous feeling is that the official sector, fairly widely defined, should be doing more to help resolve the debt problem, not only by making financial concessions and refurbishing conditionality, but also by orchestrating and taking the lead in the approach to third-world debt. An important implication of greater provisioning is that it increases the likelihood of such an expanded role for the official sector.

In the shorter term, debtor countries facing greater difficulties in refinancing their loans from the private sector may find it increasingly difficult to meet their outstanding obligations to the multilateral agencies. Some may fall into arrears. The agencies are therefore not exempt from the default concerns of the private sector.

While the banks are certainly not in a position to opt out of the debt problem, it would seem appropriate to shift the burden more toward the official sector. To the extent that provisioning assists such a shift, it could be of advantage to the international financial system. Provisioning by commercial banks will force the regulatory and tax authorities within the official sector to state their attitudes more clearly. This could result in tensions within the sector. Regulators anxious to sustain the security and stability of the financial system can be expected to welcome additional provisioning, as indeed they have done. The tax authorities, on the other hand, may not be anxious to make the tax concessions that would encourage provisioning. Moreover, the wing of the official sector that deals more directly with financial flows to the developing world may be worried about the effects of provisioning on total flows.

Finally, it would be a mistake if this discussion gave the impression that commercial-bank provisioning is of the greatest strategic importance. Many of its implications are marginal, and they are frequently uncertain. Indeed, some commentators have argued that a central implication of provisioning is the additional uncertainty it generates. Compared with the principal issues associated with the resolution of the third-world debt problem, provisioning is probably of limited importance. Its greatest significance could be as a reflection of a change in the attitude of the banks, but it is difficult to be certain of the extent of such a change.

5 Are Provisions Adequate?

One important question raised by the commercial-bank provisioning of mid-1987 is whether the level of reserves achieved was adequate. Some U.S. banks apparently concluded that it was not. The larger regional banks, like the Bank of Boston, increased provisions to about 50 percent of their LDC exposure toward the end of 1987, an increase not matched by the
money-center banks. Table 3 demonstrates the difference in reserves held by the major U.S. banks even before that, in September 1987. Among the four with the largest LDC exposures (over $8 billion each), reserves comprised, on average, 21.5 percent of LDC exposures, while in the third group, with exposures between $300 million and $2 billion, the reserve ratio was 34.6 percent, more than 60 percent higher.

TABLE 3
RESERVES OF MAJOR U.S. BANKS AS A PERCENTAGE OF EXPOSURE, BY DEGREE OF EXPOSURE, SEPTEMBER 1987

<table>
<thead>
<tr>
<th>Exposures</th>
<th>Average Reserves</th>
</tr>
</thead>
<tbody>
<tr>
<td>Over $8 billion (Citicorp, Bank of America, Chase Manhattan, Manufacturers Hanover)</td>
<td>21.5%</td>
</tr>
<tr>
<td>Between $2 billion and $6 billion (Chemical, J. P. Morgan, Bankers Trust, First Chicago, Continental Illinois)</td>
<td>26.4%</td>
</tr>
<tr>
<td>Between $300 million and $2 billion (Wells Fargo, Security Pacific, Marine Midland, Mellon, First Republic, Bank of Boston, Bank of New York, PNC Financial Corporation, First Bank System, Bank of New England)</td>
<td>34.6%</td>
</tr>
</tbody>
</table>

*Source: IBCA Banking Analysis, London.*

On top of this, some banks with smaller LDC exposures, such as Amex, have begun to talk publicly about debt relief (see Robinson, 1988) and have also begun to write down or write off a proportion of their LDC exposure. During 1987-88, for example, Republic Bank of New York wrote down some of its Mexican public-sector debt; the Bank of Boston wrote off about 20 percent ($200 million) of its Latin American loans, an action followed by two other U.S. regional banks; and Amex Bank wrote off all its private-sector loans to Latin America. In the case of the Bank of Boston’s decision to increase its provisions and write off loans, it is interesting to note that a new chairman had recently been appointed who was anxious to make an impact by raising the profile of the bank and creating the image of a “superregional.” Actions on third-world debt provided a way of generating a higher profile and attempting to create a competitive edge. This episode further confirms the possibility raised by the Citibank and National Westminster Bank decisions that internal bank politics are an important factor in explaining provisioning.

One way to approach the question of the adequacy of provisioning is to compare actual provisioning with the market discount on LDC debt. Data on the market prices of a sample of such debt over the period 1985-88 show
that, with the exclusion of Peru, the average discount on the debt of the five largest Latin American debtors was nearly 35 percent in April 1987 and about 52.5 percent by March 1988.

The connection between the size of the discount on LDC debt and the amount of provisioning required is to some extent supported by admittedly sketchy information on individual-country provisioning by the banks. In broad terms, bankers report that provisions are highest against the countries that have the greatest discount on their debt in the secondary market. The relationship is by no means perfect, however. In 1986, for example, some banks were setting aside much higher provisions against Brazilian debt than against Venezuelan debt, even though there was a marginally higher discount on Venezuelan debt in the secondary market. At the same time, provisions against Argentine debt were much higher than against Chilean debt, even though there was very little difference in the secondary values of their debt.

If the market valuation of LDC debt is an accurate indicator of risk and of its net present value, it would appear that many banks are still underprovisioned. However, it is not entirely clear whether the market valuation of debt is an accurate measure of the extent to which the banks should provision. First, there is the argument that the market is too thin and vulnerable to distortions to provide a balanced assessment of risk. Second, some bankers say that the debt is worth more to them than its market value suggests because the banks have leverage with the debtor countries. Third, bankers have maintained that their superior position with respect to participation in debt-equity swaps and the rate of return on such investments serves to raise the value of the debt to them as compared with the market valuation. Leading bankers have argued that they do not expect to have to use the entire amount of their loan-loss reserves. Moreover, some observers have interpreted the apparent unattractiveness of the December 1987 Mexican debt swap to the money-center banks to mean that the major banks still value their loans to developing countries well above the secondary-market price.

There is some doubt about these arguments. The degree of current participation gives reason to believe that the secondary market is relatively efficient and provides as good a guide as anything to the net present value of developing-country debt. Similarly, it can be argued that the leverage on policy exerted by the banks is activated via the intermediation of the IMF.

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10 For this reason, Citibank has argued that the effective discount is no more than 20 percent and not the higher level shown by the secondary market.

11 About 250 banks and 50 nonfinancial companies are reported to be trading in the market, with the turnover estimated at $10 to $15 billion. Salomon Brothers has stated that, at this level of business, market prices represent a more reliable consensus than the subjective opinions of top banking executives currently accepted by creditors.
and the World Bank, and that this will be incorporated in the market’s valuation. Furthermore, the returns to equity investment are available to all participants in debt-equity swaps and not just to the banks, and it is doubtful whether the banks possess superior information on investment opportunities. Finally, evidence provided by Lamdany (1988) suggests that the bid offer prices made by the banks for newly issued Mexican bonds were consistent with the claim that the secondary-market price is a reasonably accurate measure of perceived risk.

Taking secondary-market valuations as the best available guide to country risk, what are the implications for the banks of raising provisions to the levels that these valuations imply? Calculations suggest that additional global provisions of about $14 billion would have been appropriate in 1987, raising total global provisions to about $85 billion. By 1988, very much larger provisions would have been warranted by the sizable fall in the secondary-market price of LDC debt. Just taking fifteen U.S. banks with LDC exposure in excess of $1 billion, it would appear that by March 1988 their reserves were some $20 billion short of the required value implied by the secondary-market price of LDC debt. This suggests that these banks needed to more than double their provisions. Indeed, on this basis provisions appear, in many cases, to have been less adequate in early 1988 than they were before the increase in mid-1987. The Bank of England matrix confirms that provisions at 25 percent were inadequate in early 1988. Additional provisions in the amounts mentioned here would have important implications for the balance sheets of the provisioning banks. The general absence of further increases in reserves suggests that the banks have deemed them to have unacceptable consequences for short-term earnings, profits, and capital adequacy. Instead, many of the larger banks have attempted to increase the ratio of provisions to LDC exposures by reducing their exposures.

6 Concluding Remarks

By itself, commercial-bank provisioning has made only a marginal contribution toward resolving the problem of third-world debt. Indeed, to the extent that it discourages the banks from making new loans, provisioning has deepened rather than alleviated the financing problems faced by the highly indebted developing countries and has increased the risk of default.

Phillips and Drew, in their regular review of the U.K. clearing banks, point out how difficult it is to make interbank comparisons of the adequacy of provisions. However, the ratio of provisions to nonperforming loans for the British banking industry as a whole increased from 105 percent in 1981 to 124 percent in 1987. Thus, provisions have been rising relative to nonperforming loans, showing a more conservative attitude on the part of bank managements. Of course, this does not necessarily mean that provisions were adequate in 1987; it could simply indicate how inadequate they were in earlier years.
Yet provisioning is consistent with various approaches to the problem of third-world debt. It is consistent with an approach based on the market mechanism, since it facilitates debt swaps by the banks and the further evolution of a secondary market in developing-country debt. Banks have increasingly sought to improve their reserve ratios by reducing their LDC exposure through debt sales and swaps. Provisioning is also consistent with plans for a more highly structured approach that incorporates an element of relief for the debtors. While provisioning makes new money less likely and most bankers publicly resist the notion of debt relief, provisioning makes it easier for the banks to move toward writedowns and at least partial forgiveness.

There are compelling reasons to believe that an initiative based on the provision of some relief to debtors is necessary if the debt problem is to be managed successfully over the next few years. Factors similar to those that encouraged the banks to add to their provisions are likely to put growing pressure on them to consider the relief option seriously. If the banks do begin to make greater use of debt relief, then their decision to add to provisions in mid-1987 may be seen later as an important strategic step in their changing posture toward the problem of third-world debt.
References

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