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Regulatory and Tax Treatment of Loan Loss Provisions 1/

by

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Abstract

Provisioning for loan losses is a method for recognizing the reduction in the value of a bank's loan portfolio. Provisions are an essential element of prudential risk management and capital adequacy measurement and an important market signal. Loan loss provisions constitute a normal operating expense and should be deducted from taxable income provided that banks adhere to consistent and strictly enforced provisioning procedures, and provided that these mirror loan default probabilities. The argument for harmonized regulatory and tax treatment of loan loss provisions can be based on the economic similarity between loan losses and depreciation of machines and equipment. Tax deductibility of loan loss provisions does not imply a tax deferral or a special subsidy for banks.

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I. The Issue of Regulatory and Tax Treatment of Loan Loss Provisions

Provisioning for loan losses is a method for recognizing the reduction in the value of a bank's loan portfolio. It improves the banks' ability to account for current losses by permitting adjustments to the nominal value of a loan portfolio prior to relinquishing or altering the terms of the claim (loan repayment, loan write-off, rescheduling). Provisioning is thus a major step in the direction of market valuation of nontraded bank assets.

From a prudential perspective, the importance of loan loss provisioning is uncontested. By contrast, the tax treatment of loan loss provisions is a subject of some controversy. Rules and practices in OECD countries can be described as falling into two groups: countries with liberal tax treatment granting relatively generous tax deductions for loan loss provisions versus countries with restrictive tax treatment where tax deductibility is limited or not permitted at all. As shown below in Table 1, Canada and European Union countries tend to be on the liberal side, while Japan, Korea, Mexico, Turkey and the United States are representatives of the restrictive approach. In terms of the tax law, the United States represents the most restrictive case as the tax deductions are only accepted for loans written off the books ("write-offs").

From a regulatory perspective, restrictive tax treatment poses a serious problem of adverse incentives to banks and thus reduces the effectiveness of prudential oversight. As argued in this paper, when loan loss provisions are not, or not sufficiently, tax deductible, banks have an incentive to postpone the recognition of loan losses. This leads to an overstatement of earnings and contributes directly to the decapitalization

Table 1. Regulatory and Tax Treatment of Loan Loss Provisions in Selected OECD Countries, 1995 1/

Country	Specific Provisions		General Provisions		Interpretation 2/
	Required by Regulators? 3/	Tax Deductible?	Tax Deductible?	Required	Tax Treatment? Restrictive by Regulator?
Canada	yes	90%	yes	no	no
France	yes	100%	yes	yes	no
Germany	yes	100%	yes	partial	no
Japan	yes	50% 4/	yes	≤ 0.3% of loans	yes
Korea	yes	≤2% of loans	no	n.a.	yes
Mexico	yes	≤ 2.5 % of loans	no	n.a.	yes
Netherlands	yes	≤4% loans	yes	no	possibly yes
Spain	yes	100%	no	n.a.	no
Turkey	yes	100% 4/	no	n.a.	yes
United States	no	n.a.	yes	no	yes

1/ Excludes nonperforming loans to Less Developed Countries. The terms "specific" and "general" are used as defined in the Introduction.
2/ Based on information provided in the table and on other sources.
3/ Regulator may require adequate provisioning rules to be put in place by the bank allowing but not requiring explicitly specific and (or) general provisions.
4/ Restrictive rules apply. In the case of Japan specific provisions are only recognized as tax deductible expense if the classified loan is regarded as a loss and after collateral. In Turkey the practice is restrictive because pending court proceeding is required as evidence by the Ministry of Finance.

of banks. This is a problem especially for weak banks. For that reason, congruence of prudential and tax treatment of specific provisions can be viewed as best practice. 1/

From the prudential perspective, provisioning is an important concept because it mirrors swings in asset quality and forces banks to build up reserves for any losses incurred on problem assets. Furthermore, most of the more complex prudential standards, particularly capital adequacy rules, are based on sound provisioning practices. When sound provisioning practices are not in place, capital adequacy figures may be severely distorted. This is a problem commonly found particularly in non-OECD countries.

One factor that complicates the comparability of rules and practices is the lack of internationally agreed upon accounting and prudential standards. It is therefore useful to begin with a definition of the terms used in this paper: Loan loss provisions (a flow concept) constitute an operating expense in a bank's income statement. A distinction is made between specific and general provisions. The definitions for specific and general provisions used in this paper are based on the Basle Capital Accord.

Specific provisions refer to losses charged against defined assets. Defined assets can be individual loan contracts or groups of small, but homogeneous, loans that are evaluated using statistical methods (e.g., consumer loans, housing loans). General provisions refer to provisions

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1/ It should be noted that even with harmonized prudential and tax rules, the tax authorities maintain the right to evaluate provisioning practices to ensure that these are not abused for tax evasion.

reflecting an estimate of asset deterioration that has not yet been identified.

In terms of the balance sheet entry, specific provisions flow into a so-called contra-account on the asset side. 1/ The contra-account (a stock) thus reflects a bank's accumulated specific provisions. Following U.S. regulatory terminology, it is also referred to as the allowance for loan losses. The balance sheet entry of the general provision is on the liabilities side in a reserves account.

The argument in favor of tax deductibility refers only to specific provisions as defined above. Tax deductibility of general provisions (using the Basle definition) may also be justified under well-defined circumstances. However, the case of tax deductibility of general provision is not addressed in this paper.

Much of the controversy centers on the question whether specific provisions reflect a current (actual) loss or a future (anticipated) loss. It is argued in this paper that specific provisions are a current, though unrealized loss.2/ This argument is supported by the increasingly common accounting practice of continuously assessing changes in asset valuation rather than focusing on nominal (or historic) values. In the case of bank loans where market prices are not available, valuation changes can be assessed using loan classification systems which employ largely the same

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1/ The contra-account is an account on the asset side but carrying a minus sign so that total assets are reduced by the amount of the contra-account. Specific provisions thus reduce the value of total assets.

2/ The interpretation of loan loss provisions as a future anticipated loss is useful for the case of general provisions.

method used for loan pricing. As described below, a well defined and enforced loan valuation procedure is a central element of provisioning.

Finally, an important aspect are the costs (and benefits) of permitting tax deductibility of specific provisions. In terms of the costs, the fiscal impact of switching from a restrictive to a liberal tax regime would be a one-time event, not an annual reduction of revenue. Moreover, when taxes are assessed on a profit figure that is inflated (by not taking into account the depreciated value of the loan portfolio), as is often the case in weak banking systems, bank insolvencies and closures become more likely and these will erode the tax base of the banking sector.

Nonetheless, it must be recognized that when tax deductibility of provisions is first introduced, significant revenue shortfalls may result in the short term. For that reason, transitional arrangements may be necessary.

The remainder of this paper is organized as follows: Section II lays out the regulatory perspective and the mechanics of provisioning rules. Section III discusses reasons for dissent between fiscal and regulatory agencies. Section IV addresses further policy issues. Section V presents the main conclusions.

II. The Regulatory Perspective on Provisioning Rules

1. Provisions should mirror a reduction in loan value

From a regulatory perspective, provisioning is mandated when the value of the principal of a loan has deteriorated. In the absence of a market price for bank loans, the allowance for loan losses reflects an estimate of the losses and hence permits conclusions about the loan's current value. 1/ Current (and accumulated) provisions cover losses that have already occurred even though these losses are unrealized. Consequently, specific loan loss allowances differ from the notion of a general insurance fund or a fund for future contingencies. General provisions may play the role as an internal insurance fund.

The need for provisions should be based on periodic reviews of asset quality by management. These reviews are (or should be) subject to oversight by independent auditors and bank supervisors to enhance the accuracy and consistency of provisioning practices. Supervisory action also serves to counteract the banks' inherent inclination to recognize losses later rather than earlier. 2/

Furthermore, disclosed information on loan loss provisions--if presented in a consistent and reliable format--constitutes an important indicator by which market participants can judge the condition of a bank. Well-designed and enforced provisioning rules allow market discipline to operate as a corrective regulatory mechanism. For these reasons, provisioning constitutes a central piece of prudential regulation and supervision.

1/ The concept of provisioning, as applied by most banks, refers only to changes in the credit risk.

2/ A well-known example of this tendency is the case of country loans backed by sovereign nations in the 1970s and 1980s. Based on the assumption that sovereign nations will not default, provisioning was postponed or neglected by many international banks until new provisioning rules were written specifically for the case of country loans involving transfer risks; see Hay and Paul (1991) and IMF (1989).

2. Specific and general provisions and capital

As discussed above, a distinction is made between "general" and "specific" provisions. The definitions established in the Basle Capital Accord were made specifically in view of the elements to be included in calculating the capital ratio. Specific provisions, which are ascribed to an identified deterioration of particular assets (or known liabilities) are excluded from capital. The Basle Capital Accord defines general provisions as created against unidentified losses and freely available to meet losses which subsequently materialize. General provisions therefore qualify for inclusion in the banks' capital. 1/

In light of the Basle Capital Accord, many countries have adopted accounting practices to reflect the different nature of general and specific provisions. Specific provisions are presented on the asset side. This accounting practice underscores that the value of net assets (gross assets minus allowances for loan losses) falls when specific provisions are charged. General provisions would be presented on the liabilities side of the balance sheet.

3. Criteria for establishing and resolving loan loss provisions

To determine the extent of lost value of a loan, four main criteria are generally employed: untimely debt-service payments, deterioration in the economic situation of the borrower, deterioration in the general economic environment, and deterioration in the value of collateral. A loan classi-

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1/ They qualify for inclusion in supplementary (tier 2) capital, but may not exceed 1.25 percentage points of weighted risk assets. (See Basle Committee on Banking Supervision, "International Convergence of Capital Measurement and Capital Standards" (July 1988) Amendments to the Basle Capital Accord.")

fication system is one way of summarizing this information. 1/ For instance, a loan classification system may be composed of four classes such as "pass," "sub-standard," "doubtful," and "loss," classifying the quality of loans in descending order.

Loan classification systems are often used as a reference point for defining the level of required provisions. A regulatory authority might require that the bank must determine the allowance for loan losses for each category of classified loans such that the allowance reflects the difference between the nominal value of the loan and a fair estimate of its current value. Regulatory agencies may propose rules of thumb based on industry averages of recent years. For instance, such rules of thumb may permit banks to maintain zero percent on the nominal value of loans that are in the category "pass," but require allowances for loan losses equivalent to 20 percent for loans classified as "sub-standard," 50 percent for loans classified as "doubtful," and 100 percent for loans classified as loss (but not written off).

Several different methods can be applied to determine the extent of the loss and many regulators have stated that no single methodology is preferable. Historical data on loan losses for individual banks, peer group comparisons, and cross country comparisons are used for this purpose. Changes in the general economic environment, including cyclical fluctuations, and changes in the valuation of collateral are also considered

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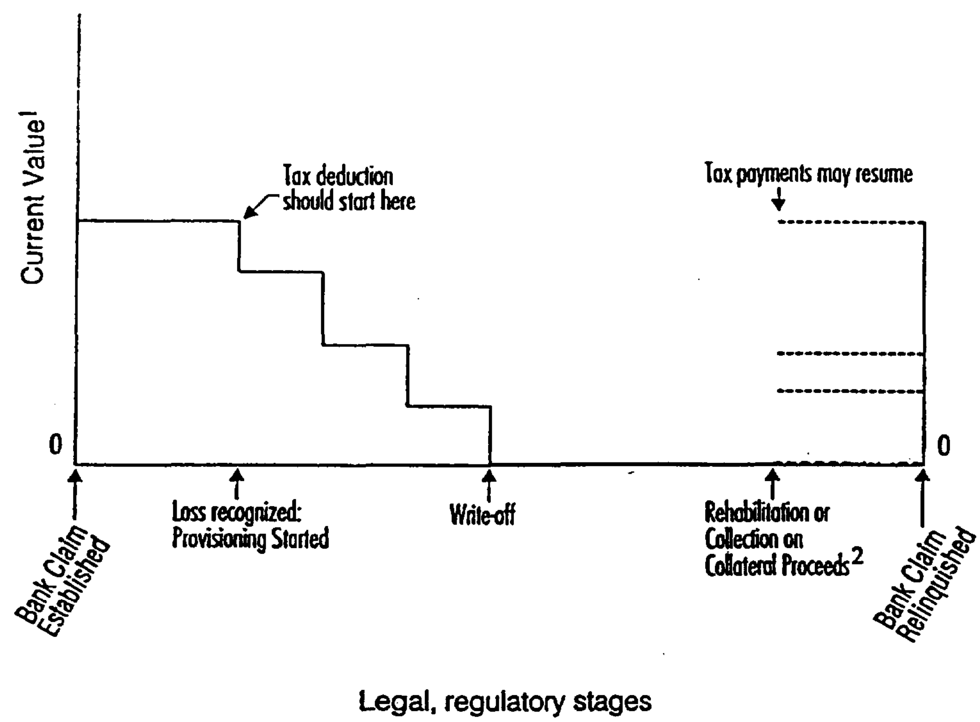
1/ Loan classification and provisioning rules vary widely across countries. In some countries, bank regulators establish very detailed criteria for loan classifications. Many EU countries reject the idea of a quantitative classification system in favor of a more qualitative approach.

in determining adequate levels of provisions. It is ultimately the banks' responsibility to devise effective systems of provisioning and it is the regulator's responsibility to verify that the banks' loan loss provisioning procedures reveal meaningful and consistent information about the true condition of banks' net worth.

Loans written off the books must be canceled against previously accumulated loan loss allowances. Accounting rules may permit (or require) that a loan is fully (100 percent) provisioned, but remains on the bank's books until it is written off. The practices for moving from fully provisioned loans classified as "loss" to a write-off depends on the regulatory and legal system. This is illustrated below in Chart 1 (discussed in more detail in Section III, below). In some countries, a loan may not be written off until the bank relinquishes the claim. In other systems, loans classified as "loss" must be written off promptly regardless of further action taken by the bank in an attempt to collect on the loan.

If the loss is fully provided for (100 percent provision), a write-off will not change the net balance sheet or the net worth. Neither will it produce an income flow. In this case, loan loss allowances and gross loans are reduced on the balance sheet. When loans are rehabilitated (for instance, from "doubtful" to "substandard"), previously accumulated loan loss allowances must be reduced by crediting provisions in the income statement. Where loan loss provisions are tax deductible, the reversal of a previously established loan loss allowance produces taxable income.

Chart 1: Life of a Loan: Legal and Regulatory Stages and Current Value



1. Measured as nominal value of loan minus allowance for loan losses. Principal is fully repayable at the end of contract.
2. Current value of the principal may remain zero or become positive.

4. The principle of conservatism

The notion of conservatism (prudence) has traditionally played an important rule as a guiding accounting principle. Prudence or conservatism in accounting is defined to indicate that possible errors in measurement should be in the direction of understatement rather than overstatement of net income and net assets. 1/ This is sometimes interpreted by fiscal authorities as a systematic bias towards overstating the need for provisioning. However, the notion of prudence is increasingly replaced by the principle of present value accounting. The extent to which existing classification and provisioning practices overstate loan losses would be a matter of empirical evidence. Both the regulatory and the fiscal authorities have a legitimate interest in verifying the accuracy of provisioning rules and practices.

5. Treatment of interest accrued but not earned

The regulatory and tax treatment of accrued interest poses an additional issue which can become particularly important in high inflation environments. For performing loans, accrual-based accounting rules require that banks recognize income from assets at specified intervals (e.g., monthly) regardless of the actual contractual agreement or actual payments. For nonperforming loans, banks are typically required to switch to cash based accounting, recording income only when it is actually paid. When interest payments, fees, or other costs accrue in the bank's books but are

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1/ In Germany, the notion of prudence is laid down in the Article 252 of the Commercial Code (Vorsichtsprinzip) and in Section 7 of the Income Tax Code (Teilwertprinzip). In the United States, a definition of prudence was developed by the Financial Accounting Standards Board (FASB) in its Statements on Financial Accounting Concepts.

not likely to be paid by the debtor, a bank overstates its income and might pay taxes on income that has not actually been received and is not likely to be received in the future. For that reason, nonperforming loans should be placed on a non-accrual status so that income is recorded only when it has actually been received.

From a regulatory perspective, criteria for placing a loan on a non-accrual status should be clearly defined to send unambiguous market signals and to prevent abuse. Criteria for placing a loan on non-accrual status should be roughly the same as those employed in analyzing loan quality, although the timing may or may not coincide with any particular classification. In some countries, non-accrual status of a loan is established when interest on an asset is due and unpaid for 90 days while provisions may be required when a loan is adversely classified which may be prior to that point. However, rules vary across countries and in some cases non-accrual status may coincide with the establishment of provisions. Placing a loan on a non-accrual status halts and often reverses the overstatement of income and should halt tax payments due on accrued but unearned income.

Accrued interest on nonperforming loans may be a very significant magnitude under conditions of high inflation where the value of the principal erodes quickly and a large part of the accrued interest represents the real amount of principal outstanding.

As far as the tax treatment is concerned, the non-accrual status as mandated or recommended by the supervisory authority should determine taxability. It is customary and reasonable that accrued income is taxable to the extent that the asset is performing and the income will be realized in due time. However, loans that have been placed on non-accrual status by regulators to indicate that payments are not expected should not be treated as accrual loans by the tax authority. Only actual income received in cash from loans that have been placed on non-accrual status should be subject to taxation.

III. Dissenting Fiscal and Regulatory Views on Loan Loss Provisioning

Dissenting fiscal and regulatory views on loan loss provisions can be grouped into two broad categories which are discussed in more detail in the following two sections.

One major point of contention is the timing of the income recognition and hence the timing of tax payments. This is an important issue because any deferral of tax payments would imply that banks are receiving a special subsidy.

A second issue concerns the level of provisions recognized by the fiscal authority. In this respect fiscal authorities sometimes argue that the principle of conservatism informing bank accounting implies a systematic overestimate of actually needed provisions. Alternatively, the authorities may simply state that for budgetary reasons it is not feasable to recognize the full amount of provisions. The latter position is often taken in transition countries where nonperforming loans may constitute a very significant share of the loan portfolio and where banks therefore would not pay any income taxes for years to come. In such circumstances, the authorities sometimes resort to limits on tax deductible provisions for budgetary reasons.

1. Do tax deductible loan loss provisions imply a tax deferral?

Restrictive tax authorities maintain that loan loss provisions imply a tax deferral because tax deductibility of provisions permits banks to claim an expense prior to the actual occurrence of that expense. On the basis of this argument, some countries recognize losses for tax purposes only when the bank has declared a "write-off." As shown in Table 1, the United States fall under this category. 1/

Restrictive tax authorities often ignore the important distinction between general reserves for potential losses and specific provisions for identified (actual) losses. A tax deferral would only be involved if a bank claimed a tax deduction for loan loss provisions over and above what is necessary to cover the loss. Any provisions that reflect a deterioration of the loan value do not entail a tax deferral.

The relationship between, and timing of, provisioning and tax deductions can be clarified using a simple chart (Chart 1) to illustrate the current value of a loan as it might pass through various stages, defined by regulatory and legal frameworks. Along the horizontal axis, tracing the legal and regulatory dimension, the life of a loan spans from establishing the loan contract until the claim is relinquished. It is assumed that the

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1/ The U.S. tax law is very restrictive; however, a full evaluation of tax deductions permitted is complicated by the fact that the U.S. tax authorities permit partial loan write-offs (i.e., where a portion of a loan is written off). In other countries, write-offs are only permitted for the entire amount of the loan while partial losses would be captured through loan loss provisions. For this reason, the tax deductions permitted for U.S. banks in any given year on any given loan portfolio may be less restrictive. Nonetheless, the intention of the U.S. tax law is to limit tax deductions to write-off and for this reason it is fair to characterize the U.S. law as an example of restrictiveness. Moreover, countries that follow the U.S. example tend to apply a restrictive practice.

loan contract entails no amortization payments, no collateral, and that the loan is repayable fully at the end. In this example, declining loan performance mandates provisioning, and as loan performance continues to deteriorate, additional provisions become necessary until finally the loan is written off. 1/ In many countries, a loan may have been written off (for regulatory and tax purposes) even though the legal claim remains and the bank continues to pursue the claim through its legal department or through the courts. The claim is relinquished once the loan has been repaid, the bank has collected on its collateral, or abandoned the legal claim for other reasons.

The current value of the loan is measured on the vertical axis. It is equal to the nominal value of the loan contract when the bank first establishes the claim and begins to decline as the bank recognizes a loss and establishes a provision. At that point, the value of the loan portfolio would be adjusted downwards by subtracting the value of the loan loss allowance from the nominal value of the loan to arrive at the figure for net loans. The current value falls to zero when the loan is fully provisioned and written off. At a later date, the bank may begin collecting on the collateral or the loan may be rehabilitated. The rehabilitation process can result from several circumstances--for instance, if the borrower returns to solvency. The current value at that time would depend on the details of rehabilitation or collateral realization and is shown as dotted lines in

1/ A variant, not shown in Chart 1, would permit partial write-offs of a loan. U.S. tax authorities recognize partial write-offs as tax deductible expense. Partial write-offs reduce the need for provisioning on any given loan. In practice, partial write-offs may, at least to some extent, be substitutes for provisioning.

Chart 1. When the claim is finally relinquished, the current value once again falls to zero.

Applying the general rule that tax deductions should begin with the recognition of a loss, tax deduction should begin when the current value has actually declined as shown in Chart 1 and continue while the current value of the loan declines until the value has reached zero. Any income received after the loan was written off would be taxable.

2. Does the principle of conservatism imply systematic tax deferrals?

In some countries, the fiscal authorities permit tax deductions for a portion of loan loss provisions. As shown in Table 1, this is the case for Japan, Korea, and to a lesser extent, the Netherlands. 1/ In these countries, the tax treatment can be considered restrictive although the definition used in the Netherlands, where provisions are tax deductible up to 4 percent, would be liberal under normal circumstances when loan loss provisions are substantially below the level of 4 percent, as has been the case in the past decade for which data is available. The Netherlands is therefore classified as "possibly" restrictive as shown in Table 1. In Japan, the fiscal authority recognizes only 50 percent of specific loan loss provisions and in addition applies restrictive rules to write-offs. However, the Japanese authorities have recently relaxed the practices of tax deductibility for write-offs. This was done using the Cooperative Credit Purchasing Company (CCPC) established in the wake of the banking problems in the 1990s. The CCPC purchases nonperforming loans from banks, thus making

1/ In response to the banking problems in the early 1990s in Japan, the fiscal authorities had begun to adopt more liberal practices, although the tax rules were not changed.

it possible for banks to realize losses. These losses are fully deductible from tax income.

Tax authorities recognizing loan loss provisions as a tax deductible expense are concerned that banks may overstate the need for provisions and that bank regulators tolerate biases in this direction. The principle of conservatism which continues to guide accounting rules in many countries may be interpreted by the tax authorities as a systematic overstatement of expenses and hence an understatement of taxable income. 1/ This would imply that banks receive a subsidy in the form of a tax deferral which would be a legitimate concern for the fiscal authorities.

This concern may be justified when banks are operating in highly profitable environments and have a tendency to over-provision as a way to hide part of their net earnings. However, banks operating in competitive markets or subject to pressure from shareholders to pay out high dividends have strong incentives to minimize rather than maximize loan loss provisions. More importantly, banks operating in weak banking systems tend to underestimate the need for loan loss provisions. Hence, in most countries, over-provisioning is unlikely to be an issue.

Nonetheless, the concern is legitimate and therefore, as with all operating expenses, the fiscal authority should always maintain the right to review all expenses claimed by banks (or any other taxpayers) and pass its own judgement on the adequacy of loan loss provisions claimed as expense by each bank. In well-functioning banking systems, however, the fiscal

1/ This argument is not limited to banks as the principle of conservatism is not a bank-specific one.

authorities rely heavily on the regulators' assessments. From time to time, small discrepancies may result, and these can be corrected.

3. Loan loss provisions and depreciation allowances

From the regulatory perspective, the estimated current value of the loan based on a loan classification scheme constitutes the most rational basis for determining the bank's current income and should therefore also be applied by the tax authorities. Loan loss provisions should be viewed as a normal operating expense and tax deductibility should be granted on these grounds. In this respect, the banks' loan loss provisions are the banks' equivalent counterpart to depreciation allowances for fixed assets (machinery and equipment). Capital extended in the form of a loan is the banks' main productive asset and, hence, provisions for problem loans should be seen as the wear and tear of the loan portfolio, the bank equivalent of wear and tear of industrial machinery.

Fiscal authorities in most countries permit enterprises to depreciate fixed assets (machines and equipment) on the assumption that wear and tear as well as technological innovation reduce their value over time. Depreciation allowances are generally tax deductible regardless of whether or not a loss has been realized. Depreciation allowances often follow a grossly simplified schedule such as "straight line" annual deduction over a given number of years. By comparison to most depreciation schemes, loan loss provisioning systems are a considerably more precise mirror image of the loan portfolio's current value.

4. Loan write-off versus relinquishing of claim

A further issue may arise because legal and accounting practices generally permit banks to write off loans without relinquishing the claim. Therefore, at a later date the loan may be recovered. The fiscal authorities may argue that a "true" loss is one that is irreversible and on these grounds the tax authorities in some countries recognize losses only when the claim has been relinquished. For purposes of taxation (or regulation), a notion of irreversible losses is not very useful; neither is it applied for depreciation allowances for other fixed assets. In the case of industrial machinery for instance, depreciation rules never require that the machine be removed as proof of the actual write-down. Depreciation schedules for tax purposes generally do not preclude the possibility of selling the machine for a positive value after it has been fully depreciated. Any cash receipts from the sale of a fully depreciated asset would, of course, be taxable income. The same rules should be applied for banks. Since the write-off may not be identical with the point at which the contractual claim is relinquished by the bank, a written-off loan can be rehabilitated or rescheduled and thus return to the bank's balance sheet at a later time. Rehabilitation would take the form of taxable income, reversing any previous losses.

There are strong reasons for separating the write-off from relinquishing of the claim. The process of legal follow-up and the collection on collateral frequently takes considerable time, and postponing tax recognition for this reason would lead to a protracted overstatement of bank profits. Shortening the process of loan collection is often counterproductive especially when collateral must be liquidated. By their very nature, most collateral claims involve real estate property where a fair market value may not be realized within a short time.

5. Fiscal rationales for harmonized tax and regulatory treatments of loan loss provisions

From the fiscal perspective, there are several reasons for introducing taxation rules that are in harmony with current valuation accounting. First, as discussed above, loan loss provisions are similar to depreciation allowances and should be treated in the same way for tax purposes.

Second, when tax authorities adhere to static concepts (such as the point at which the loan is written off), while banks are employing dynamic concepts of current valuation accounting, banks have an incentive to work around the static tax definition to evade taxes.

For example, if only write-offs are tax deductible, banks may attempt to try to accelerate the write-off in order to receive tax recognition for the expense that has already occurred. Since rules for when to write off a loan largely follow the banks' own internal risk-management system, banks have some discretion in determining when to write off a loan. Such a strategy would presumably translate into higher rates of "recovered loans" (with the associated tax payments at the later date). This, in turn, forces the fiscal authority to define more precisely when a loan is considered a write-off and to enforce the use of this term. In some countries, tax authorities have seen a need to resort to further measures such as to recognize write-offs only when recoveries remain within certain limits. But this causes similar follow-up problems (and associated enforcement costs) for the fiscal authority because a basis for determining acceptable levels of write-offs must then be established. 1/

6. Why tax treatment of provision is a regulatory concern

A tax policy that does not recognize loan loss provisions as a tax deductible operating expense poses a problem from the regulatory perspective because it may contribute to the bank's decapitalization and because it weakens the banks' incentive to provision adequately. When provisions are not tax deductible, they become an after tax expense, lowering the bank's profits and its ability to pay out dividends. This is an unpopular measure and hence bank management has an incentive to find ways of reducing provisions. On the other hand when provisions are tax deductible, they enter into the pool of normal operating expenses and the after-tax income is then freely disposable to the bank owners.

Tax authorities may dismiss the incentive problem and argue that market pressure will force banks to set aside sufficient provisions, thus counteracting the incentives to underprovision due to the tax treatment. 2/ This argument is not convincing, however. As explained above, provisioning is necessary because of the nontradeable nature of bank loans. The market therefore does not normally have the basis for evaluating what an appropriate level of provisioning would be. 3/

1/ From the regulatory perspective, the write-off is less important to define than the provisioning procedure. Once a loan is fully provisioned, the formal write-off is not of great importance from a regulatory perspective.

2/ T.S. Neubig and A. Sullivan (1987), for example, make this argument in the case of the United States.

3/ Market valuation of problem loans to sovereign borrowers appears to have been an exception. See Frenkel, Dooley, and Wickham (1989) for a literature overview and discussion of this case.

IV. Further Policy Issues

1. Phasing in tax deductibility of loan loss provisions

In many transition and developing economies, taxes paid by banks contribute considerably to the overall tax revenue. In many of these countries, the application of international accounting rules reveals that even loss-making banks are paying taxes. 1/ Introducing full tax deductibility of loan loss provisions may entail a massive reduction in revenue. Even though the adverse impact on tax revenue is a one-time event rather than a permanent reduction in tax revenue, the overall impact may need to be spread out over several years.

To distribute the revenue effect over several years, the authorities may see the need for phasing in tax deductibility of loan losses. In some countries in Central and Eastern Europe, for instance, fiscal authorities place limits on permitted deductions for loan loss provisions relative to total assets irrespective of the level of provisions mandated by regulators. This and other methods may be useful in spreading out the fiscal impact over several years.

2. International coordination of regulatory and tax treatment of loan loss provisions

Increasing globalization of financial markets provides incentives for national regulatory and fiscal authorities to cooperate. It also provides a strong reason for harmonization of regulatory and tax treatment of loan loss

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1/ Such capital transfers to the government budget may boost revenues in the short run, but may lead to major fiscal expenditures at a later date when the government may be called upon to bail out depositors of failing banks.

provisions. The nonperforming country loans held by international banks during the 1980s were a prominent case in point. International debt renegotiations were protracted and complicated because banks were operating under widely varying regulatory and fiscal systems which defined their short-term strategies for loan renegotiations. National differences in regulatory and tax rules provided incentives for some banks to recognize losses by calling the loan in default while other banks saw regulatory or tax advantages in postponing the recognition of any losses. Responding to market pressures, some countries made exceptions to existing rules for the case of certain country loans in accordance with other countries. However, international practices continue to vary widely both regarding the regulatory and the tax treatment of loan loss provisions.

V. Conclusions

Properly administered loan loss provisions are an essential element of prudential risk management and capital adequacy measurement. With well-defined disclosure, loan loss provisions also represent an important signal for market participants of a bank's condition. Specific loan loss provisions are a normal operating expense, and they should be deducted from taxable income. The arguments in favor of tax deductibility of specific loan loss provisions are similar to the case of depreciation allowances for machines and equipment. Like depreciation allowances, loan loss provisions reflect a reduction in the value of the banks' assets that should reduce taxable income accordingly.

It was argued that when provisions are not tax deductible, the banks' incentives to establish and maintain adequate provisions are weakened.

There may also be compliance costs associated with a divergent regulatory and tax treatments; these can be considerable when accounting systems are not sophisticated.

Systems for loan loss provisions are a major step toward market value accounting of bank assets and should be recognized by the fiscal authorities. This conclusion implies that tax deductibility of loan loss provisions does not constitute a tax deferral or a special subsidy for banks. Reasonable limits must be established to ensure that loan classification and provisioning rules reflect best estimates of current loan losses.

One policy implication is that bank regulators should make an effort to harmonize regulatory and tax treatments of loan loss provisions. A second policy implication is that global competition in banking requires international harmonization of loan loss provisioning and its tax treatment.

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