10 DOWNING STREET

From the Private Secretary

Prime Minister

Although there are elements in Sir Walter's scheme which are desirable - greater marketability of loans, more non debt financing - his scheme as a whole is subject to major defects as the Treasury and Policy Unit notes make clear.

Do we really want Western Governments to take over bad loans? or to make huge subsidies? Is the solution suitable for Mexico really suitable for Argentina?

AT
19/9

19 September 1984

PRIME MINISTER

Walter Salomon is right in his analysis of the origins of the problem, right in urging the transfer of real assets from those countries that owe money to the creditors and right to want a market in dud debt. More enthusiastic acceptance of the need for equity finance of new ventures in the Third World is an essential part of any recovery package, and more should be done to explore methods of achieving this. It may be best to confine this to new money rather than attempting to convert existing loans into equity.

A step-by-step approach to a market in bad debt would be preferable to his big bang solution. There are already precedents as some syndicated loans are switched from bank A to bank B, and there is a market in country risk debt, as with the Mexican bonds, which can give people some guidance on the true value of these assets. Under his scheme a bank could be obliged to give its bad loan to the International Realisation Company, it could then buy it back (paying expenses on the way) only to have to give it back again if the status of the loan deteriorated further!

Walter Salomon's plan would succeed in putting much of the cost of solving the present problem on Western taxpayers through the tax break mechanism he propounds. Much better as a relief to the Third World would be sound financial policies in the United States leading to lower US interest rates.

The dangers in his scheme are:

1. The existence of the International Realisation Company could precipitate a worse crisis than it is designed to alleviate. It could, for example, encourage more debtor nations to renege on their obligations or to seek a soft deal.

2. The Realisation Company could work at the expense of the shareholders of independent commercial banks and requires deliberately changing the basis of solvency calculations in a way which weakens the institutions. Whilst any solution to the problem should make the shareholders of commercial banks that have made bad loans bear the brunt of the adjustment, and not the taxpayers, this method could worsen the banks and shareholders' plight unnecessarily.

3. To avoid a future crisis, Walter Salomon effectively recommends the nationalisation of most international lending from here on. This is likely to get the Western countries into worse trouble, both because governments will be no better at assessing risk than the shareholders and managers of commercial banks have

been, and because the existence of a specific government pledge behind a given loan could make it even more tempting for a debtor nation to demand a renegotiation.

New equity finance for the Third World is vital, one-off renegotiations will sometimes be needed and some money can be routed via the IMF. But let's not put into being a supranational body with wide-ranging powers to interfere in the practices of commercial banks, with powers to subvene Western taxpayers' money to come to the support of the Third World on the grounds that world trade will then be expanded.

JOHN REDWOOD

6.23

cc NO

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

19 September 1984

Andrew Turnbull Esq
10 Downing Street
LONDON
SW1

Dear Andrew,

INTERNATIONAL DEBT

On 13 September you sent us a pamphlet containing a proposal for resolving international debt problems which Sir Walter Salomon had shown to the Prime Minister. I attach an appraisal of it, as you requested.

In your letter you refer to the proposal for special tax credits. We too are unclear as to precisely how the scheme would work. It appears that banks' corporation tax liability would be reduced to the extent that they abated interest rates payable by debtor nations. Whatever the details, it would amount to a massive subsidy to debtor countries.

You also asked about the accounting procedure for loans in the temporary stewardship of the Realisation Company. This does not appear to be of crucial importance to the general intention of the scheme. The procedure followed would depend on accounting practices in individual countries. It might make most sense for banks to ascribe to such loans the value of similar debt which had already been sold.

I am copying this to John Bartlett in the Governor's office.

Yours ever,

Judith

MISS J C SIMPSON
Private Secretary

SIR WALTER SALOMON'S PROPOSALS ON INTERNATIONAL DEBT

Summary of proposals

Sir Walter Salomon's proposals can be summarised as follows:

(i) the creation of an "International Realisation Company", supported by the Western central banks. This would take non-performing loans into temporary stewardship, market them on the banks' behalf, and pay them the proceeds. It could renegotiate loans with debtors, and "repackage" for sale loans made by different banks.

(ii) Developed country governments would grant tax credits to banks in respect of interest payments on loans to troubled debtor countries. The details are unclear. But the intention is that the benefit would pass on to debtors in the form of lower interest payments - ie the tax system should be used indirectly to give debtors a subsidy.

(iii) Developing countries should be more welcoming to foreign equity capital, and permit the sale of existing assets to foreigners. Future borrowings should be on a fully secured basis.

(iv) Banks whose balance sheets were badly hit by loan sales would have to be reconstructed. This might involve separating non-performing loans from performing loans, with the two parts of the bank being backed by separate shares (the 'A' and 'B' shares in the scheme which Sir Walter previously mentioned to the Prime Minister).

(v) Banking supervision in the UK should be carried out by an independent body of bankers, not by the Bank of England.

Analysis

2. Sir Walter Salomon's scheme is founded on the assumption that the international banking system is close to collapse ("the spectre of default is visible on all sides".) Neither we, nor any of the other Summit countries, nor the IMF share this view, though there are considerable downside risks in the current situation. In our view the current case-by-case strategy, despite many uncertainties, continues to be sustainable. So the premise on which the scheme is based is in our judgement misconceived.

3. Nor are we attracted by the idea of giving debtor countries a subsidy, which would mainly benefit middle-income developing countries. Even if we were, it is not obvious that the most efficient way of doing so would be through the tax system. In 1983 bank debt service payments by all developing countries were around $50 billion. So tax relief at the corporation tax rate in the lender countries concerned would cost up to perhaps $20 billion to $25 billion a year, including perhaps £2 billion a year in the UK. If this interest subsidy were payable only on problem loans, as Sir Walter proposes, this would encourage debtors to relax efforts to continue servicing loans properly, in order to qualify. Commercial discipline on the banks would also be weakened.

4. We agree, however, with Sir Walter on the importance of encouraging an increase in more stable forms of finance such as direct and equity investment, and are continuing to press developing countries to be more receptive to this.

5. We also see some attraction in greater marketability of bank debt, which the proposed realisation company is a way of achieving. In principle, marketability has the attractions of giving a market value to bank debt - which may be more appropriate than the full book value. Risk might be spread to non-bank investors. But so far, banks have not engaged in large-scale marketing of their debts, because of legal

restrictions in some countries, scarcity of potential purchasers, and reluctance by banks and debtors to see debts traded at prices substantially below book values.

6. It is difficult to see what would induce banks to give their problem loans to a realisation company. They would run the risk of receiving considerably less than the book value when loans were sold. Sir Walter says that, as an inducement for banks to join the scheme, regulatory authorities should disregard doubtful loans in calculations of capital ratios for solvency purposes. But this would mean a much tougher stance than currently exists in developed countries, and would in practice not be achieved over the timescale Sir Walter has in mind. An added difficulty could be that loans may generally not be sold without the authority of the borrower; who would not welcome the large discounts which could occur when a loan was sold, as this would indicate their credit standing and affect the cost of new money.

7. It is not clear how loans would be treated in the banks' accounts while under the stewardship of the realisation company. It might be necessary for the banks to ascribe to them the value of similar debt which had already been marketed, although this would depend on the accounting procedure in individual countries (in the UK it might be possible for the loan to keep its full value until actually sold).

8. As loans were sold, banks' financial positions could become very precarious, as Sir Walter admits. Much would depend on the speed with which the realisation company marketed the debt - rapid sales could lead to lower prices. In the meantime, pressures could build up for the realisation company to help service the debts in its stewardship - with taxpayers' money. And, since central banks, through the BIS, would be backing the company, they would come under strong pressure to rescue banks which were in difficulty as a result of loan sales.

9. Sir Walter proposes that non-performing loans be separated off from performing loans, and that banks raise new capital

to carry on business. But it is possible that banks' liabilities, used to fund problem loans sold by the realisation company, might exceed levels which could be covered by new capital issues - as in the case of Continental Illinois. If such liabilities were not met by other banks by means of measures such as the "safety-net" arrangement for Continental, which required central bank involvement, the financial system generally would face severe difficulties.

10. The Treasury does not share Sir Walter Salomon's doubts about the effectiveness of Bank of England supervision. Bank officials engaged on this specialist work are not generalist civil servants, but experienced central bankers of high international standing. Supervisors have statutory independence from political interference. We doubt that the transfer of supervision to a committee of practising bankers would improve supervisory standards; there would in any event be problems of conflict of interest and security of commercial information.

Conclusions

11. Sir Walter starts from an extreme view that the stability of the international financial system is not sustainable under present policies. He is right to advise greater non-bank investment in developing countries. But his proposal for tax credits on loan interest would mean massive government subsidies. His proposal for a realisation company, while based on a view of the desirability of marketability of debt which has some attractions in principle, would cause substantial difficulties in operation. While there remains scant evidence of any non-bank interest in taking on ldc debt, it is wiser to develop marketability step by step, in co-operation with the banks, rather than introducing a grandiose scheme involving a new institution. It would not be helpful to take supervisory functions away from the Bank of England.

Econ Pol: Indebtedness Pt 4

8