CONFIDENTIAL

B

Prime Minister

The pay brief is important. I have had the tax brief condensed (flag C)

MCS 1/2

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

Michael Scholar, Esq
No 10 Downing Street
LONDON SW1

1 February 1983

Dear Michael,

... I enclose some briefing notes for the Prime Minister's lunch with the clearing bank chairmen tomorrow - they cover the following subjects:

a. the clearers' pay negotiations (negotiations start on 3 February);

b. provisions for bad debts

i. figures for general provisions for bad debts, which appear in the accounts and include the (smaller) specific provisions relevant to tax;

ii. the Inland Revenue's recent letter to the banks about specific provision for bad debts;

c. the Chancellor's decision not to impose additional taxation on the banks in the 1983 Budget.

... I also attach background notes by the Bank of England on the clearers' activities in support of recession-hit companies, and on some international points.

Yours sincerely,

Jim Rutter

pp J O KERR

CONFIDENTIAL

ANNEX A

CLEARERS PAY

Background

The claims by the two unions in the clearing banks are for increases of 8% in the case of the CBU and in the case of BIFU £9 a week or 10%, whichever is greater, with a minimum wage of £90 for everyone over 20. The next negotiating meeting between the clearing banks and the unions is on Friday 4 February.

2. Before Christmas the Chancellor urged the case for settlements in the financial sector close to the 3½% public expenditure provision for pay increases in 1983. The employers line will be decided on 3 February.

3. In the insurance sector offers in the range of 4 to 5% have been made by the different companies and have been rejected by the unions. One company is, however, understood to be about to implement a 4½% offer which has been accepted by one union.

4. Recent exchanges between the Chancellor, the Governor and the Chairmen of the clearers have shown that the Chairmen

a. regard an opening offer of 3½% as provocatively low; but

b. want the settlement to be 4½% or a little higher and certainly not above 5%.

Points to Make

5. a. It is essential for the economy as a whole that pay increases and settlements should fall again in this round. The fall in the exchange rate makes that even more necessary - not only fur further progress on inflation but for competitiveness and jobs.

b. Compared with a year ago the RPI increase is now down to 5.4%. This puts in perspective settlements below 5%.

c. The clearers' settlement is likely to influence pay negotiations throughout the financial sector in the rest of the year: Scottish clearers, TSBs, Finance Houses and many others. The settlement for the key clerical grades will also have an impact on the non-industrial Civil Service negotiations.

d. There are particular arguments for a settlement well below the RPI increase in the case of the clearers.

e. In recent years the banks and other institutions have made settlements which led to earnings growth in the financial sector 2-3% faster than in the economy as a whole.

f. The clearers have no recruitment or retention problems in the key clerical grades.

g. A low pay settlement would help profitability which has been depressed by lower interest rates /though this is in part being recouped through sharp increases in bank charges/ and by international debt problems. High retentions are particularly needed this year to help improve or at least maintain capital ratios.

h. wrong to undermine 4½% increase being implemented by one insurance company.

i. The clearers' settlement should be well below 5%.

Defensive

6. True that general level of settlements in the private sector seems to be about 5-6%. But clearers' settlement needs to be below that, see sub-paragraph 5e. above.

7. The NHS settlement was equivalent to 4½% from 1 April. The local authority manuals are expected to accept an offer of 4½% on 11 February. The engineering settlement was 4.8%.

CLEARING BANKS' BAD DEBT PROVISIONS FOR 1982

In the first half of 1982, the/provisions* of the four main clearing banks almost doubled to £330 million from £167 million in the first half of 1981. Since then the Royal Bank of Scotland Group have published their full year's results for the year ending 30 September 1982 showing provisions of £31 million against £13 million in 1981 while Lloyds Bank International's results recorded an increase in provisions to £115 million from £44 million. Those banks whose financial year ends at the end of December 1982 will now be in the process of finalising their provisions. Confidential indications given to the Bank suggest that the charge for provisions in the second half of 1982 is likely to be higher than in the first half of the year.

Figures and August press comment attached.

* The general provisions appear in the accounts and include the (smaller) specific provisions which are relevant to tax.

BAD DEBT PROVISIONS

London Clearing Banks 1979 to 1982

	1979	1980	1981 First Half	1981 Second Half	1982 First Half[2,3] (Interim)
	£m	£m	£m	£m	£m
BARCLAYS	55	130	60	80	115
LLOYDS	11	68	24	62	62
MIDLAND	12	83	38	75	75
NATIONAL WESTMINSTER	40	120	45	(3)[1]	78
TOTAL	Whole Year 118	Whole Year 401	Half Year 167	Half Year 214	Half Year 330

NOTE 1: reflects bunched recovery of provisions from earlier years.

NOTE 2: details of provisions for second half 1982 are not yet known but are expected to be worse:

Barclays report on 7 March 1983;
Lloyds report on 18 February 1983;
Midland report on 9 March 1983
National Westminster report on 15 March 1983.

NOTE 3: Barclays, Midland and Lloyds commented that provisions had been particularly increased on foreign business (private as well as public sector); Lloyds mentioned South America especially, Midland and Barclays North America.

Banker
August 1982

Inten●ve care

Iigh interest rates and the world ecession are blamed by all four JK clearers in reporting excepionally high provisions for bad and loubtful debts which have cut into rofits for the latest half-year to 30 une 1982. Barclays has suffered he worst in this respect with rovisions totalling £115·4 million, lashing profits by 15% over the ame period last year to £236·5 nillion. Midland's profits fell to 95·1 million, down by 9% on ven last year's disappointing firstalf results, after deducting a nassive £75 million charge for rovisions, over 80% of the pre-tax rofit figure.

Both Lloyds and NatWest, lthough reporting increased total rovisions, managed to raise profits rom last year, Lloyds by 10% to 193·1 million, and NatWest by ·6% to £214 million. But, lthough it was Lloyds which egistered the best profit growth, it lso showed the biggest increase in ad debt provisions at £62·1 nillion, more than double last ear's first-half figure. NatWest harged the highest provisions fter Barclays at £78 million, hough significantly only £68 nillion of this total was applied to pecific provisions compared with 138 million for Barclays (reduced o £115 million overall by ecoveries and a credit to general rovisions).

Barclays puts the blame for this startlingly high figure on its US operation where a £25 million profit in the last half of 1981 has been turned into a £23·5 million loss this half, largely through bad and doubtful debt provisions in respect of three specific (but unnamed) customers. Earnings for the international operation overall were down from £129·0 million in the second half of last year to £63·7 million in this half, due mainly to the US problems.

Midland has also been hit in the United Sates, by the poor performance of its newly acquired subsidiary Crocker National. Crocker's extensive portfolio of non-performing real-estate loans and its loss-making fixed interest rate advances have been the culprit there.

Lloyds does not break down its figures between international and domestic profits but declares that on the international side earnings were down over the previous half-year. It also suffered a £14·2 million exchange deficit on translation of foreign currency working capital largely due to the devaluation of the Argentine peso. No mention is made of any other damage suffered by the bank to its Argentine interests, though chairman Sir Jeremy Morse noted that international conditions were affecting 'both sovereign and corporate borrowers around the world'. At NatWest the international banking division held its own, increasing its contribution to overall profits from 32% to 34% compared with the same period last year.

Both Lloyds and NatWest are pleased with their domestic performance although suffering somewhat from the decline in the level of non-interest-bearing current accounts as a proportion of overall deposits. Sterling advances are up 24% at Lloyds and 14% at NatWest in the last six months while net interest income has risen by only 2·7% and 4·8% respectively over the previous half-year. The lower increase in net interest income for Lloyds, despite its big jump in advances, is indicative of the lower margin business it appears to be attracting from its competitors. Average base rates fell from 13·7% in the previous half-year to 13·4% in this, compounding the squeeze on all the bank's margins.

Midland has been hit hardest by the UK recession, particularly by poor results from its domestic subsidiaries. Hefty provisions for bad debts have been necessary at its Northern Bank group, while both Clydesdale Bank and Thomas Cook have turned in reduced profits. Sterling advances for the whole group rose only 10% in the period. At Barclays, advances rose by just under 14% and the bank showed modest growth in domestic profits from £184·7 million in the last half-year to £203·3 million this time. It too has been affected by falling interest rates, narrowing margins and increased bad debt provisions. Barclaycard has made a significantly greater contribution to group profits but Mercantile Credit has had a poor first half.

All four banks have emphasised that they are helping customers caught in the recession—'to the limits of prudence' says Barclays—and the domestic figures should be seen in this context. Barclays has over 500 medium to large customers in 'intensive care' while the Midland quotes a figure of 70 major companies. With little prospect of immediate relief to this gloomy picture, full-year results are unlikely to match last year's extraordinary growth for any of the clearers. ●

UK BANKS INTERIM RESULTS

Jan-June 1982, £ million	Lloyds		NatWest		Midland		Barclays	
Net interest income (% change*)	590·5	(+29·4)	704	(+18·1)	668·9	(+12·9)	915·7	(+13·5)
Pre-tax profits (% change)	193·1	(+10·5)	214	(+8·6)	95·1	(−9·0)	236·5	(−15·6)
Taxation	48·0		32		34·0		67·2	
Earnings per share (% change)	75·2p	(+0·7)	75·8p	(+3·1)	28·9p	(−31·0)	44·9p	(−23·2)
Bad debt provision (% change)	62·1	(+155·6)	78	(+73·3)	75·3	(+96·6)	115·4	(+93·3)
Current cost pre-tax profit (% change)	129·5	(+22·5)	139	(+9·4)	46·0	(+39·4)	136·5	(−14·0)

*Over the half-year to 30 June 1981

TAX TREATMENT OF COUNTRY-RISK DEBTS

The tax treatment of country-risk debts is an important consideration for the banks at this particular time of the year, as they draw up their accounts for 1982. Some concern had been expressed about the extent to which they could claim a tax deduction for"specific provisions" in respect of doubtful international debts - particularly those where the overseas governments have rescheduled the debt or interest payments and are therefore not technically in default. (This was not helped by some un-informed press comment.)

The country-risk debt issue is not a new one - countries have been in trouble both pre-war and post-war. But the <u>scale</u> of the problem - the number of countries in difficulty, the spread of banks concerned and the size of the amounts involved - is new.

Talks have taken place between the British Bankers' Association and the Revenue, as a result of which the Revenue sent the Association a letter on 17 January, at the Association's request, setting out the general tax principles in respect of bad or doubtful debts, and focusing on how in practice these principles apply in the special case of country-risk debts.

These principles are not new. The letter codifies the Revenue's view of the law in relation to the tax treatment of debts generally. One of the points made is that the rescheduling of a debt does not in itself necessarily preclude some writing down for tax purposes. The need for rescheduling usually indicates that the debtor is in some difficulty.

The Association has sent the letter to its members, and, in response to a Parliamentary Question from Mr Tim Smith, MP, the Revenue published it as a Statement of Practice on 25 January (copy attached). The Statement has been widely welcomed.

INLAND
REVENUE
Press Release

INLAND REVENUE PRESS OFFICE, SOMERSET HOUSE, STRAND, LONDON WC2R 1LB
PHONE: 01—438 6692 OR 6706

25 January 1983

[3x]

COUNTRY-RISK DEBTS

In answer to a Parliamentary Question yesterday, the Minister of State at the Treasury, Mr John Wakeham MP, said that, with the agreement of the British Bankers' Association, the Inland Revenue would be publishing the text of a letter sent to the Association on 17 January 1983, indicating the principles which the Board of Inland Revenue consider appropriate in applying the tax law to the consideration of country-risk debts.

The text of the letter is included in the attached Statement of Practice (SP1/83).

Note of Editors

The letter of 17 January was written at the request of the British Bankers'Association, for the guidance of their members. It sets out the general principles which the Inland Revenue have always regarded as applying in law to the tax treatment of debts generally.

Statement of Practice

SP 1 / 83
Date 25 January 1983

INLAND REVENUE, SOMERSET HOUSE, LONDON

FURTHER COPIES OF THIS STATEMENT MAY BE OBTAINED BY CALLING AT OR WRITING TO THE PUBLIC ENQUIRY ROOM, NEW WING, SOMERSET HOUSE; STRAND, LONDON WC2R 1LB.

COUNTRY-RISK DEBTS

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

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

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

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

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

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

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

/ f.

ANNEX C

TAX AND BANKS

Background

In the 1982 Budget the Chancellor announced several measures designed to reduce the amount of tax shelter available to the banks. He said that while these measures would help he would be giving further thought

> "to the problem of how best to ensure a sufficient contribution to tax revenues from the banking sector".

2. A report has been prepared and the Chancellor has decided that, given lower interest rates and mounting bad debts (see Annex B (ii) on loans to countries and companies in difficulties, current circumstances were inappropriate for the imposition of additional taxation on the banking sector in the 1983 Budget. The banks have not been told about this decision, though they may guess it.

Defensive Brief

"No doubt the Chancellor will make his decision known at the appropriate time."

CONFIDENTIAL

INTERNATIONAL DEBTS

Issue

To what extent can banks claim tax relief for international loans which go sour?

Line to Take

Relief is available under the normal rules relating to the tax treatment of bad or doubtful debtors. In the case of international loans, this will normally be when a debtor country gets into actual difficulty - either defaulting completely or rescheduling its loan repayments.

Discussions have taken place between the British Bankers Association and the Inland Revenue. The Revenue have issued guidance on above lines. The banks are now understood to be happy.

worried that law & practice
where reschedule short default
always have IR - now clarified
(ill-informed Press comment)

Domestic Side

In addition to the important role the banks are playing in the international banking arena, they are being equally supportive on the domestic front in supporting UK companies in difficulties.

In recent years British industry has come to rely more and more on the banks for their outside finance, as the pressures of inflation and the high interest rates had closed off until last year the alternative of raising long-term fixed rate finance through the corporate bond market. Last year 80% of companies' external financing was provided by the banks; fifteen years ago that proportion was less than one-third. Although overdraft financing remains the predominant form of bank lending, the banks have made very positive and encouraging efforts to increase the level of their term lending to replace overdraft financing wherever practicable.

The length and depth of the current recession has confronted the banking system with problems which have required the banks to adapt many of their traditional ideas of prudential lending. And while, for instance, the aggregate average level of capital gearing remains at a tolerable level of around 30-40% for listed companies, the banks are continuing to support a significant number of companies with debt/equity ratios well in excess of these levels. The need for increased support in difficult cases is, of course, one of the reasons why the banks have substantially increased in recent months their provisions for possible bad debts.

Apart from making additional facilities available to companies which have a real prospect of recovery once demand picks-up, given the right financial support during the interim period, the banks have shown themselves able to respond with an encouraging degree of flexibility and innovativeness to the variety of problems they face. They are willing to participate constructively in discussions with other interested parties, s uch as institutional shareholders, in capital reconstructions of company balance sheets and in the right circumstances to convert part of existing debt into share capital which is of immediate benefit to companies' capital and income gearing and cash flow. The banks have also been increasingly willing to discuss and implement, in conjunction with institutional shareholders, changes where necessary to strengthen management; this development is an important part of the improvement in the banks' monitoring of their corporate customers which should play an increasingly important role in identifying problems at an early stage enabling action to be taken well in advance of a possible crisis.

A particularly good example of the banks working in close harmony with other financial institutions, and government, was in the recent formation of Sheffield Forgemasters, which brought together the forging interest of Johnson & Firth Brown and BSC. As part of this package the banks converted £5 mn of debt into convertible unsecured loan stock with a matching subscription from financial institutions and BSC, as well as converting some overdraft facilities into term loans. Another important case is Massey Ferguson where the participation of the UK banks led by Barclays alongside ECGD is a crucial part of the scheme for the reconstruction of this important international group with major UK interests.

BANK OF ENGLAND

AIDE-MEMOIRE ON INTERNATIONAL POINTS

The IMF has encouraged the international banks to play their part in finding a solution to the debt difficulties of Mexico, Brazil, Yugoslavia (and Argentina). The Bank of England and the Fed have given their support, and recognised that an increase in exposure may in certain circumstances improve the quality of existing loans - in particular where it is part of an internationally coordinated package of support and an IMF adjustment programme has been put in place.

2. The clearing banks have assumed the responsibilities between them for coordination and leadership of the London banking community under the negotiations now in progress with Mexico, Brazil, Argentina and Yugoslavia. This involves a good deal of administration. They have co operated both with the Bank of England and among themselves to share the load as follows:

Mexico: Membership of the international Advisory Group of Banks: Lloyds Bank International

Brazil: Liaison group for international overall coordination: Midland and Lloyds Bank International.

Project I new money Midland.
Project II rescheduling of 1983 maturities: Lloyds Bank International.
Project III trade-related credits: National Westminster.
Project IV interbank liabilities: Barclays.

Argentina: Member of international working group Lloyds Bank International (who, with Barclays, run domestic banks there).

Yugoslavia: Member of the Advisory Committee: Barclays Bank International

<u>Poland</u>: Member of the Steering Group: Barclays Bank and <u>Lloyds Bank International</u>

Member of the Advisory Committee: <u>Midland</u>

<u>Romania</u>: Member of the Steering Committee: <u>Barclays Bank International</u> and <u>Lloyds Bank International</u>

3. For some time the clearers have had a Sovereign Risk Committee, set up with the encouragement of the Bank of England, which meets to discuss the problem countries. While playing their part the clearers have stressed that they are willing to do so only on the principle of burden sharing. This means both a contribution from the whole banking community, the official side and international financial institutions.

4. And the burden has been shared. There are the resources provided by the IMF (and our support for an enlargement in the size of the Fund, and the enlarged GAB). Closer home, there were the HMT guarantees for the Bank of England contribution to BIS loans to Mexico ($140 million ex $925 million), Brazil ($110 million ex $1.2 billion). ECGD $150 million for Mexico. [Some bankers have sought assurances that the governments contribution to Mexico will be on all fours with theirs, with a maximum maturity of six years on new money, eight years on rescheduled loans. No commitment has been made on the terms of the ECGD facilities, and nor would it be helpful in general to do so. However the contracts which benefit will be subject to the usual terms appropriate for the individual projects, each of which will be negotiated independently. Final maturities are expected to be at least five years and could be as long as eight. Thus the terms, which are for new money, compare favourably with those of the commercial bank contribution.]

5. The Inland Revenue has written to the banks to clarify the position on tax relief, on specific provisions in respect of sovereign loans which have been rescheduled - and the banks are thought to be happy with the position.

6. The banks have now agreed to set up Ditchley II ("Institute of International Finance") and hope it will be operating from March (optimistic). Its precise role and functions remain unclear - eg how far will it operate as a clearing house for information about country risk and exposure?

7. Mexico has so far raised over $4.7 billion towards their target from international banks of $5.0 billion and Brazil nearly $4.0 billion towards $4.4 billion.

THE COMMITTEE OF LONDON CLEARING BANKERS

10, Lombard Street, London EC3V 9AP

SECRETARY-GENERAL
LESLIE W. PRIESTLEY

TELEPHONE
01-283 8866

CHAIRMEN'S LUNCHEON : 2ND FEBRUARY, 1983

1.00 for 1.15 P.M.

The Rt.Hon.Margaret Thatcher, M.P., Prime Minister

Mr.M.C.Scholar, Private Secretary to the Prime Minister

Sir Robert Fairbairn, J.P., Chairman, Clydesdale Bank PLC

Mr.R.Leigh-Pemberton, Chairman, National Westminster Bank PLC (Chairman, Committee of London Clearing Bankers)

Mr.T.H.Bevan, Chairman, Barclays Bank PLC (Deputy Chairman, Committee of London Clearing Bankers)

Sir Jeremy Morse, K.C.M.G., Chairman, Lloyds Bank Plc

Sir Donald Barron, Chairman, Midland Bank plc

Sir George Kenyon, J.P., D.L., LL.D., Chairman, Williams & Glyn's Bank plc

Mr.J.G.Quinton, Director and Senior General Manager, Barclays Bank PLC (Chairman, Chief Executive Officers' Committee)

Mr.K.S.Lucas, Secretary-General, Committee of London Clearing Bankers

---ooOoo---

A

THE COMMITTEE OF LONDON CLEARING BANKERS

10, Lombard Street, London EC3V 9AP

SECRETARY-GENERAL
LESLIE W. PRIESTLEY

TELEPHONE
01-283 8866

CHAIRMEN'S LUNCHEON : 2ND FEBRUARY, 1983

1.00 for 1.15 P.M.

The Rt.Hon.Margaret Thatcher,M.P., Prime Minister

Mr.M.C.Scholar, Private Secretary to the Prime Minister

Sir Robert Fairbairn,J.P., Chairman, Clydesdale Bank PLC

Mr.R.Leigh-Pemberton, Chairman, National Westminster Bank PLC (Chairman, Committee of London Clearing Bankers)

Mr.T.H.Bevan, Chairman, Barclays Bank PLC (Deputy Chairman, Committee of London Clearing Bankers)

Sir Jeremy Morse,K.C.M.G., Chairman, Lloyds Bank Plc

Sir Donald Barron, Chairman, Midland Bank plc

Sir George Kenyon,J.P.,D.L.,LL.D.,Chairman,Williams & Glyn's Bank plc

Mr.J.G.Quinton,Director and Senior General Manager, Barclays Bank PLC (Chairman, Chief Executive Officers' Committee)

Mr.K.S.Lucas, Secretary-General, Committee of London Clearing Bankers

---ooOoo---

King Wm St

10 DOWNING STREET

PRIME MINISTER

I attach:

1. List of guests (Flag A)

2. Treasury brief (Flag B)

cc: Mr. Scholar

1 February 1983