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LOAN LOSS PROVISIONING AT BANKS AND TAXATION

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Abstract. This article is devoted to the consideration of the development of loan loss provisioning at commercial banks and issues of their taxation. In addition, the article analyzes the issues of losses on bank loans in terms of the amount of profitability and its distribution, economic conditions, as well as determining relation to the regulatory capital. Moreover, this research views different approaches to deducting reserves on loan loss provisioning when taxing profit of banks.

Keywords: standard loan, sub-standard loan, unsatisfactory loan, doubtful loan, non-performing loan, special reserves, profit subject to tax, tax deductions.

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Introduction. The role of the banking sector in the financial system of the country is a necessary and indivisible part of ensuring full and timely tax payments to the state budget, which in turn definitely reflects in the overall national economy. Currently under complicated and unconvenient conditions, a number of positive and negative factors affect the development of the economy of the countries. One of such factors is current state tax policy affecting entrepreneurial activity (Lelikova and Konvisarova, 2014). Therefore, under current conditions of the modernization of the national economy, the taxation of the banking sector is considered to be an important component of public finance (Jukova et al, 2014). Konvisarova, Samsonova and Vorozhbit (2015) suppose, taxes do not serve as a principal institution in the development of banks, however, optimization of taxation enables to activate other instutions that affect the development of the banking sector. The main issue was associated with the risks since under economically unstable conditions credit institutions challenged significant problems as after determining a taxable base there was no use for creating loan loss provisioning. On the contrary, the possibility of reducing the reserve allocation to banks' deductible expenses would increase the sustainability of banks, thereby making a positive impact on the overall banking sector (Kichigina and Konvisarova, 2016). Over recent years, the possibility of raising tax deductions on covering loses on bank loans has been considered by the agencies developing statutory acts and regulating authorities. It is crucially important to understand that tax concessions can make a significant impact on the creation of reserves to repay losses on loans as the reserves aimed at covering losses are considered to be very important for banks and their financial reporting (Ryan 2011; Beatty and Liao 2014). Andries K., Gallemore J., Jacob M. (2017) in their research investigated the analysis of the impact of the corporate tax system on the financial reporting of banks with the account of the losses on loans. According to their opinion, the system of corporate income taxation is classified into two aspects in terms of impact on the loan loss provisioning: rate of the corporate income tax and tax concessions on loan loss provisioning. If there is tax deduction for total reserves, the increase of the rate of corporate income tax by 1 percentage point will result in average increase in reserves by 4,9 percent.

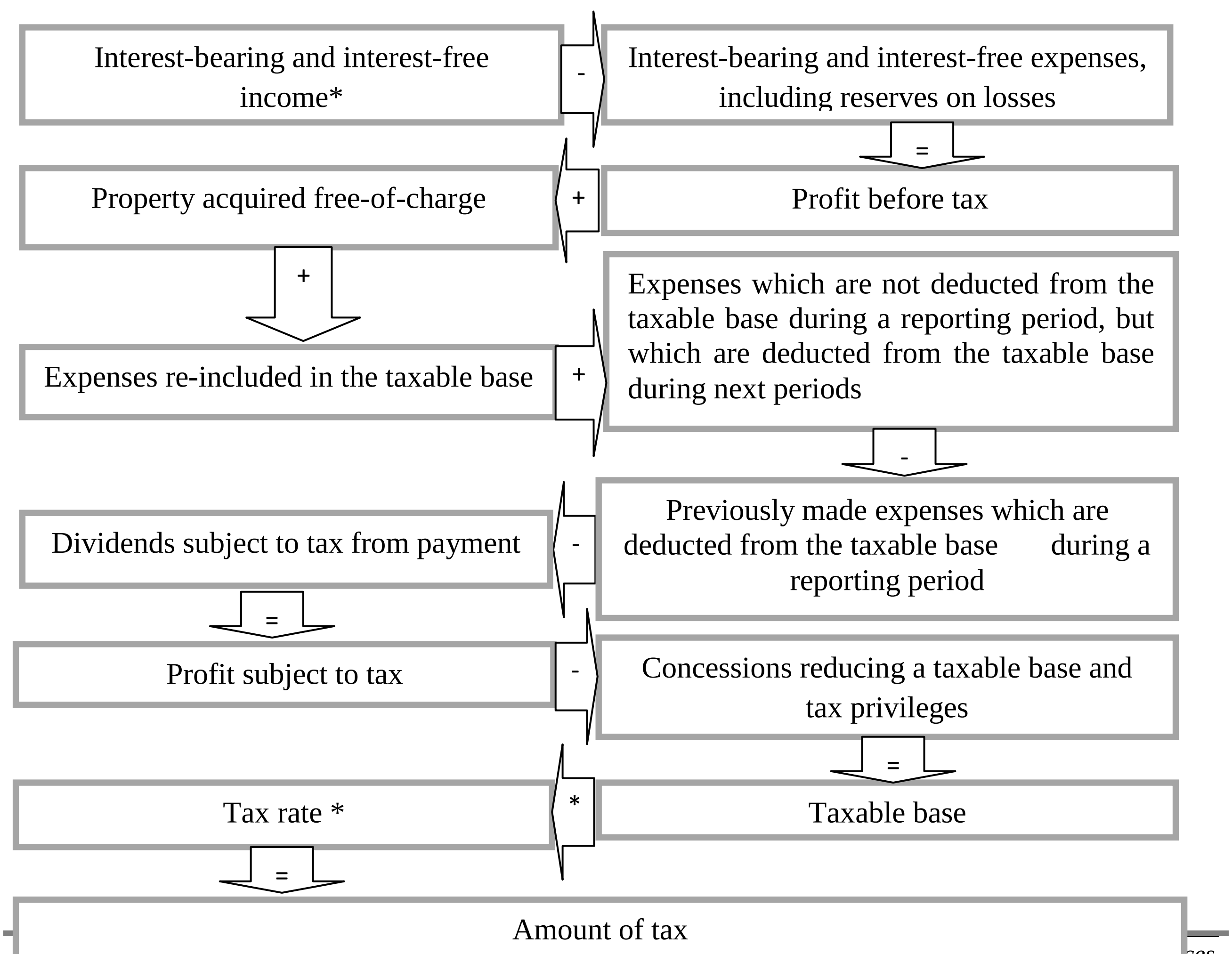
In general, the results of the analysis illustrate that corporate taxation system promotes timely refection of losses on loans and in turn, corporate taxation is a significant factor in the transparency of the financial reporting of the banking sector. In the majority of countries banks are required to recognize loan loss provisioning for financial reporting purposes, and tax deductions in relation to these reserves are a common phenomenon in tax regimes. In some countries the amount of tax deductions are determined in reliance on the rate of the corporate income tax. In addition, there are two mechanisms that can affect loan loss provisioning through the system of the corporate taxation. First of all, the system can facilitate timely deterioration of banks' credit portfolio in the reserve, which is often called timely recognition of losses on loans. At the same time, the corporate tax system can encourage high risks for loans, if the banks have already provided tax concessions on reserves in the process of banks' decision-making on risks regarding formulation of the credit portfolio. These mechanisms create various regulatory consequences. It should be noted that previous studies have been primarily related to the transparency of the bank's data as it provides timely information on the bank's financial position and the risk for lenders and regulators, as well as taxation may have potentially destabilizing effects on the overall banking sector (Bushman and Williams 2012, 2015; Gallemore 2016). In particular, Bushman and Williams (2012, 2015) think that delay with determining of expected losses contributes to the following three different risk levels, in particular, the reduction of the balance of banks, the decrease of the sensitivity to risk of systemic financial events, and the risk of a downturn in the overall banking sector. Meanwhile, reduction of the delay with determining of expected losses is associated with a high risk of a significant decrease of the banks' balance during the downturn period. De Vincenzo and Ricotti (2014) suppose, that according to the forecasts of tax authorities and policy-makers, corporate taxation system may contribute to the deterioration of banks; credit portfolio in timely recognition of losses on loans, thus contributing to the transparency of banks' balances. Loan loss provisioning constitutes more than half of the total bank payments and this fact justifies significant changes in the major part of total expenses (Beatty and Liao 2014).

As it is obvious, the study of the impact of the corporate income tax system on implementation of the coverage of losses on the corporate income tax has proven that the amount of reserves will increase in the income tax rate if reserves are not taxed. In addition, the conclusions of the research indicate that the impact of the corporate tax system plays an important role the timely recognition of losses on loans. At the same time, the corporate taxation system can replace regulatory provisions for a stable banking performance by encouraging banks to raise their loan loss provisioning. Finally, it has been proven that reimbursement of losses on loans affects the choice of the amount by banks in the United States in compliance with the rule of tax deductions. In general, previous researches on the impact of the corporate taxation on the banking sector (for example, Admati et al. (2013) are devoted to the issues of determining the impact of the corporate taxation on the banking sector and they provide the conclusion that the system of corporate taxation can result in timely recognition of losses on loans, which, in turn, will enhance transperancy of the overall banking system.

Analysis. As the practice illustrates, in Uzbekistan like in many other countries banks are generally taxed, and in some cases there are specific features of taxation (preferential or favorable taxation) while imposing taxes on banking services. For example, in many countries where financial services are exempted from the VAT, in order to determine the amount of profit which is subject to taxation, loan loss provisioning by assets can be included in the structure of deductible expenses. Under current taxation system almost all financial services provided by commercial banks are exempted from the VAT (tax rate constitutes 20%) (Tax Code, 2007), If banks affiliate their property to their branches, this process is not considered to be the VAT turnover. However, if banks sell the property accepted as collateral, the taxable base for the VAT incorporates the value added tax imposed. Herewith the amount of the debt is determined as the positive difference between a sale price and cost of the collateral.

It should be noted that the main aspects of the taxation of banking activities are related to the profit tax. According to the current tax legislation, the cost of the property transferred by commercial banks to their branches, as well as the amount used to create reserve to cover possible losses on loans are deducted as expenses. According to the tax legislation, due to the termination of the obligations, the borrower’s bankruptcy, his termination (in case of a legal entity) or death, the debts arising as a result of the term of the claim shall be deemed as non-performing and the amount subject to deduction on doubtful debts shall be deductible in the amount not exceeding the amount of the outstanding debt (Tax Code, 2007). Tax Code of the Republic of Uzbekistan (article 148, 2007) states interest income on loans issued under the guarantee of the Republic of Uzbekistan and loans with a grace period on interest payments issued in accordance with resolutions of the President of the Republic of Uzbekistan or the

Cabinet of Ministers of the Republic of Uzbekistan, which deadline for receiving has not occurred in accordance with the loan agreement, is not considered as taxable income. In addition, interest accrued on the loan, which has received non-accrual status, is written off from income accounts in accordance with the procedure established by the Central Bank of the Republic of Uzbekistan (Regulation, 2004). Accordingly, accrued interest on these assets is taxed on profits in the reporting period. When banks perform the state registration of primarily issued securities, issued securities (infrastructure bonds and options are excluded), they pay the duty to the state budget in the amount of 0,01% from the nominal value of these securities, and in case of previously registered securities in the amount exceeding the nominal value by 0,01 (Law, 2015). Dividends are taxed as the source of paying interest, however, interest paid to the credit agencies is not subject to taxation. They are added to the interest-bearing income of credit agencies and taxed at the rate of 20% according to the generally-established order. Profit tax is considered the major tax among all taxes paid by banks. In addition, profit tax paid by banks has very complicated peculiarities and its calculation can be illustrated by the following chart (Figure 1).



*according to the established order, interests on loans which are considered to be non-accrued are deducted from the income accounts.

**taking into consideration the share of long-term investment financing of credit portfolio, the current rate of profit tax can be reduced up to 30%.

Figure 1. General scheme of imposing profit tax on banks

It should be noted, that the most outstanding aspects of imposing profit tax on banks are the following: interest accrued on the loan which has received non-accrual status, is written off from income accounts in accordance with the procedure established by the Central Bank of the Republic of Uzbekistan and the value of property affiliated by commercial banks to their branches is deducted as expense and exempted form profit tax. In addition, the income-bearing interest on doubtful and non-performing loans which acquired the status of non-accrued interest is written off. This situation demonstrates that calculation of non-accrued interest is accounted in so-called “unexpected circumstances” account and is subject to tax according to the established procedure.

Bank capital and loan loss provisioning. Banks are considered financial institutions which attract funds through deposits and extend loans to finance the consumption, investment, capital expenditure of individuals, companies and governments, thereby ensuring economic growth. With the aim of minimizing credit risk, banks create reserves to cover expected losses on the credit portfolio. Definitely, the valuation of the losses on loans used to mitigate the loss of banks by the credit portfolio is a credit risk management tool. Supervisory bodies and developers of accounting standards have constantly been paying a particular attention to the reserves created at banks to cover possible losses on bank loans. As a result of the analysis, in many banks all over the world the delay of creating reserves to cover losses on non-performing loans, due to the cyclical economic downturn, will raise the impact of the economic cycle on bank profitability and capital. Moreover, different countries use different practices for creating reserves on losses on loans. In this regard if all the problems related to the application of various instruments to cover losses on bank loans haven’t been solved, new agreements of Basel cannot achieve pursued aims (Laeven & Majnoni, 2003). According to Basel I requirements, the amount of the regulatory capital in relation to assets weighted to risk should constitute at least 8% and it is required to cover three types of risk: market risk, credit risk and operational risk. Basel I states that reserves on loan losses of the II level capital should constitute 1,25% to the assets weighted to risk and this limit can be adjusted in any country to meet the requirements to regulate the banking sector (BCBS, 2001). If expected losses are higher than reserves, banks must deduct the difference from the capital (by 50% from the capital of the I and II levels). If expected losses constitute the amount less than reserves, banks must get the difference in the amount of maximum 0,6% from the II level capital in relation to assets weighted to risk (BCBS, 2014). Standardized approach requires banks to identify risk categories based on external credit ratings. The main goal of the Basel II agreement is to improve the quality of risk management in banking, which in turn should strengthen the stability of the financial system as a whole. Structurally, Basel II is divided into three parts - three components: 1) calculation of minimum capital requirements - represents the calculation of the total minimum capital requirements for credit, market and operational risks; 2) supervisory process which covers the basic principles of the supervisory process and risk management; 3) market discipline. The main disadvantage of Basel II in terms of creating loan loss provisioning is that it is possible to create these reserves only once during a reporting year (at the beginning of a year or a quarter or half-yearly). It has been expected that this practice will have the most significant impact on the dramatic improvement in the quality of risk management in most banks. In addition to introducing a risk-sensitive credit risk assessment, many of them will pay a particular attention to operational risk for the first time - one of the main risks of commercial banks (along with credit, liquidity and market risk) (Hull, 2012; Wezel et al., 2012). Basel III was developed in response to shortcomings in financial regulation and strengthens the capital requirements of the bank and introduces new regulatory liquidity requirements (Wezel et al., 2012). All of these reserves are created by banks by attributing to expenses. Each of them has its own direction of using accumulated funds - this is covering losses from a specific active operation, that is, the reserve for one type of active operations cannot be used by the bank to cover losses on other types of active operations. That is why reserves for active operations are often referred to as corresponding reserves. Actually created reserves for active operations are not used to cover losses from banking activities in general. The transfer of funds to reserves is carried out before the deadline for the presentation of the monthly balance (Anandarajan et al, 2007; Perez et al. 2008; Curcio, Dyer, Gallo, and Gianfrancesco, 2014; Bouvatier et al., 2014; Skala, 2015; Ozili, 2017b). In the research made by Norden and Stoian (2013) it is stated that if income from loan loss provisioning at banks is very high and if expected dividends are much lower than current income, it is required to maintain high profitability and low level of variability. In addition, from the point of view of Krüger et al (2018), according to IFRS (International Financial Reporting Standards) GAAP (Generally Accepted Accounting Principles) creation of loan loss provisioning can cause reduction of I level capital which can constitute an additional burden for banks. As analysis shows, during the period of economic downturn the banks which couldn't maintain the adequate level of capital experienced a bad quality of the credit portfolio, which, in turn, raised credit risks to a great extent. In addition, reserves on loan losses enhance amenability of the requirement to the banking capital to the cycles. As the results of the research illustrate, the amenability to use the created loan loss provisioning to reduce profit of the bank is related to the amount of income and its distribution, economic situation, in particular, during economic downturn and crisis, requirements set for regulatory capital (Ozili and Outa, 2017).

It should be noted, that in reliance of results of studying world experience, the factors determining the level of loan loss provisioning in various countries are different, and the fact that peculiarities of these factors haven't been properly assessed has been widely criticized.

Loan loss provisioning and taxation. Creating loan loss provisioning when taxing profit of banks is considered to be significant as during taxation period reserves enable to reduce a taxable base for profit tax. According to the procedure developed by the Central Bank, there have been created reserves to cover possible losses on the loans classified as "standard", "substandard", "doubtful", "non-performing" (Regulation, 2015). In particular, good loans with insufficient information in the loan file or lack of documentation on collateral can also be classified as "standard" loans. For loans classified as "standard", the bank is obliged to create reserves in the amount of 10% of the outstanding principal amount. For loans classified as "substandard", the bank is obliged to create reserves in the amount of 25% of the outstanding principal amount. For loans classified as "doubtful", the bank is obliged to create reserves in the amount of 50% of the outstanding principal amount. For loans classified as "non-performing", the bank is obliged to create reserves in the amount of 100% of the outstanding principal amount. In addition, in reliance upon the reduced ratings assigned by international rating agencies «Standard & Poor's», «Fitch Ratings» ва «Moody's Investors Service» assigned to assets placed with the banks outside the country, if loans classified as standard or sub-standard have overdue payment of interest they can be clarified as non-performing. Due to loan loss provisioning created by commercial banks, the principal of non-performing loans can be redeemed at the expense of these reserves. Since transferring redeemed non-performing loans and interest thereto to the accounts outside the balance items, during the period constituting at least 5 years, they should be reflected in the account "Unexpected circumstances". Both the principal and interest thereto of non-performing loans reflected in this account during the period of 5 years after its transfer into this account can be written off on the basis of the resolution approved at the General Meeting of Shareholders of the Executive Board of the bank. In compliance with the tax legislation, when determining taxable profit of credit agencies reserves on standard, substandard, doubtful, and non-performing loans are included in the deductible expenses. According to the Tax Code of the Republic of Uzbekistan, in terms of non-performing loans, the principals of non-performing loans are not included in the taxable base only according to the court decision (except for the amount of covered written-off interests).

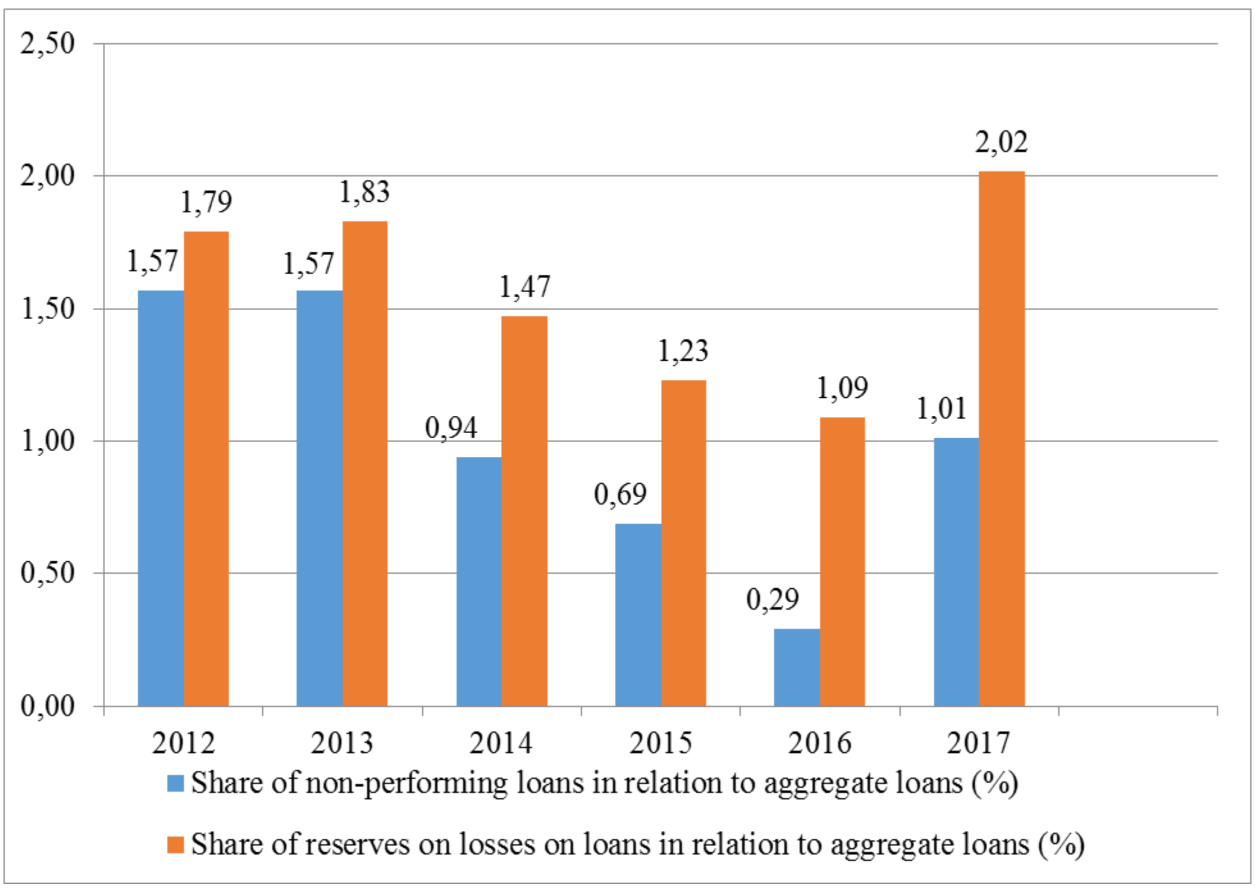


Figure 1. Non-performing loans and loan loss provisioning

Source: Analytical review of the banking sector of Uzbekistan for 2012-2017.

“Ahbor-Reyting” Rating Agency.

As it is seen from the data, the difference in the amount between problem loans («unsatisfactory», «doubtful» and «non-performing») reserves created on losses by loans is quite high. This justifies the fact that the banks having enhanced their expenses by 10% on special reserves on substandard loans can reduce the amount of profit subject to taxation. In addition it should be noted that taxation regimes of reserves created at commercial banks to cover possible losses on loans significantly differ across various countries. For example, in Australia, Korea, Malaysia, and the Philippines, only the deductible method is used, and only losses on non-performing loans are admitted. In particular, the Philippines applies the practice where with the aim of taxation it is expected to write off the balance the debts approved by the Central Bank. In some countries (Japan, Thailand), there are limits for tax deductions for losses on loans. In particular, in Thailand, banks may deduct the loan loss provisions, which may be deducted from the tax base at the rate of 25% of net profit or 0,25 % of total unpaid gross loans, whichever is less. According to the tax legislation, loan losses are deducted only in case of a civil suit or disclosure of a bankruptcy or death in respect to the debtor (Sunley, 2003). In the United States, taxation of banks is based on the general provisions of corporation taxation with the exception of the 1986 Tax Code (Internal Revenue Code, 1986). In particular, a taxable base should be reduced by the amount of expense on partially or fully depreciable non-performing loans during the reporting period (Internal Revenue Code, 1986). However, there is a restriction on reserves for reimbursement of non-performing loans to banks. The banks owning assets worth up to 500 million USD are allowed to cover loan losses to meet the required level of reserve supervision at the end of the year. The level of this reserve is determined empirically by the increase in the amount of all debts of the bank to the amount of losses determined (average for the previous 6 years). Russia applies the following amounts for loan loss provisioning: for substandard loans from 1% up to 20%; for doubtful loans from 21% to 50%; for problem loans from 51% to 100%; and for non-performing loans - 100%. Tax authorities seem to suggest that banks raise the amount of reserve provisioning and that some of the costs are not economically substantiated. This illustrates that according to the classification of loans to this or that category, a significant impact can be made to determine a base for a profit tax as according to article 315 of the Tax Code these expenses are deducted from the profit tax base (Barskaya, 2017).

As it turns out, the amount of loan loss provisioning can cause reduction of a profit tax base of banks at the reporting period and enables to the transfer of taxes already paid to the next reporting period. It should be noted that II level capital of banks includes the current net profit of 1,25% of the total amount of assets subject to risk for reserves created on standard loans (assets), combined liabilities (equity and debt capital) including preference shares, and one third of I level capital should contain 45% of the excess amount of assessed value of the subordinated debt and the initial value of assets (Regulation, 2015).

There is no unified international approach in terms of taxing loans loss provisions. Some countries use the method of writing-off in terms of loss provisioning, while the others apply the loan loss provisioning method for the purpose of regulatory accounting. In determining the order of taxation of loan loss provisioning, in particular, defining the amount of the bank profitability, the following is considered to be necessary: determining a for loan loss provisioning (writing-off or creating reserves); achieving full or partial compliance of taxation of loan loss provisioning with its regulation; setting limits for using tax concessions for loan loss provisioning.

Conclusion. In the researches conducted, currently banks tend to use loan loss provisioning not only for the purpose of capital regulation, but as an instrument for managing income gained from these reserves, particularly during the period after introducing Basel requirements. According to the results of the research, the loan loss provisioning enables to raise amenability of bank requirements to a cyclical tendency. In addition, loan loss provisioning is closely associated with overall economic situation and requirements set for regulatory capital. Thus, the Basel requirements for loan loss provisioning constitute 1,25% for II level capital and each country can raise that limit to meet the regulatory requirements of the banking sector.

As a result of the analysis made in terms of countries throughout the world, loan loss provisioning can be defined as material or cash reserves created in case of need. This part of material, financial resources is temporarily excluded from circulation and serves as a source from which resources are used in case of emergency. Compulsory reserves are funds accumulated by commercial banks which are kept in a reserve account in the central bank to ensure liquidity of deposit debts or other passive operations of banks. General reserves are the funds mobilized by the bank at the expense of the bank's profit after tax to recover unforeseen losses from various types of uncertain risks. To cover losses from banking activities in general, according to the results of the fiscal year, commercial banks create a reserve fund, which, in essence, is a general reserve, that is, a reserve of funds to cover losses from statutory activities. Special reserves are funds mobilized by a commercial bank to cover doubtful debts, unforeseen losses, losses from active operations. Formation of special reserves is carried out at the expense of bank expenses. In this regard, taxation issues appear significantly important.

Uzbekistan has its own practice of imposing profit tax on commercial banks. In this regard, there are no tax limits for deducting expense for loan loss provisioning. In addition, the property transferred by commercial banks to their branches is deducted from the profit tax base, as well as the interests on non-performing loans with have non-accrued character can be written off from the income accounts.

Summarizing above-mentioned statements with the aim of ensuring compliance of regulation of the banks' performance and taxation issues, as well as imposing taxes on loan loss provisioning it is recommended to implement the following:

- proceeding from the amount of assets (applicable only for banks with up to 10 trillion UZS which constitutes approximately 86% out of all banks) giving permission to carry out contributions to reserve requirements as deductible expenses for banks;
- establishing the amount on reserve requirements by reduced profit tax with the account of the average sum of loans extended during 5 previous years or at the amount of 25% from the net profit;
- carrying out provision of non-performing loans due to reserves created on the accounting method (10% for the 1st year, 20% for the second year, 30% for the third year, 40% for the fourth year).

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