B. The New Bank of England Rules for Provisioning

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I Introduction

In August 1987 the Bank wrote to all UK incorporated institutions authorised under the Banking Act which had exposures to countries experiencing debt repayment and servicing difficulties to encourage them to reconsider the adequacy of their provisions against exposures to such countries. The Bank of England developed a framework for objective analysis for measuring the extent of the difficulties of each country (known as the matrix). During the last two years this framework has been used as a basis for discussions between the Bank and each institution so that an appropriate level of country debt provisions for supervisory purposes can be determined.

In January 1990 the Bank of England reviewed the structure of the matrix and the factors contributing to the assessment of repayment difficulties. The Bank has also looked again at the level of provisions indicated by the matrix, bearing in mind the widespread market perception that the situation among debtor countries has on balance deteriorated. The result of this review is reflected in a number of technical changes in the matrix and *in a significant increase in the average level of provisions produced by its application.*

Besides the increase in the average level of provisioning, there are two significant changes. The first concerns the source of the minimum score of 10 from category A and B factors. Previously, evidence of *actual* default was required before the question of provisioning arose; provisioning could not be triggered by category C (economic) factors alone. The Bank now believes it right that indicators which provide evidence about the *likelihood* of debt repayment difficulties in the future, even without actual default, should be capable of triggering provisioning; therefore, while the minimum score of 10 remains, it now applies regardless of the source.

Secondly, in order to avoid sudden changes in future provisioning requirements the Bank believes that a smoothing technique should be introduced based on a moving average.

II The New Bank of England Matrix

There are three stages in the process of deciding an appropriate level of provision:

(i) to identify countries with current or potential repayment difficulties;

(ii) to identify the nature of those difficulties and the extent of the country's problem; and

(iii) to determine, at this point, what proportion of exposures to that country is unlikely to be repaid in full.

A number of factors or criteria can be identified to help make this decision. These factors can be incorporated in a matrix and weighted to reflect their relative significance for determining the appropriate level of provision in respect of an exposure.

The Bank of England groups them into three categories, namely:

A Factors which evidence a borrower's inability or unwillingness to meet its obligations, whether at the due date or thereafter;

B Factors which show a borrower's current difficulties in meeting its obligations; and

C Factors which provide evidence of the likelihood of repayment difficulties either persisting or arising in the future.

The matrix includes a total of 16 factors under these three categories. They can be applied to any country and to any type of exposure taken either in aggregate or by type of exposure. The Bank of England's aim has been to identify a range of observable factors which point to the likelihood of a partial or total failure to repay. For this reason differing levels of maximum score are attributed to the different factors, reflecting their perceived relative weight in the aggregate assessment of repayment difficulties.

The factors and the weights attaching to them are set out in the matrix attached. Only one factor (16) is to be weighted within a range according to individual judgement.

It is suggested that a minimum score of 10 is required before the appropriateness of provisioning needs to be considered.

Methods of Scoring

The total score for a country is the sum of the individual scores for each factor. Changes in the circumstances of individual countries should be taken account of by updating country scores whenever

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provisioning levels are redetermined.

In order to avoid excessive volatility in the scores, the Bank considers it appropriate to take a moving average over 15 months, starting from the date of this paper, as the basis for determining the level of provisions.

Setting the Level of Provisions

Once the moving average has been determined, the Bank of England instructs that levels of provision should be established within broad bands, shown below:

Score	*Provision* Jan 1990
10-24	5-13%
25-39	14-23%
40-54	24-37%
55-69	38-58%
70-84	59-75%
85-99	76-89%
100-119	90-96%
120-145	97-100%

If one compares the January 1990 matrix (Table 1) with the one issued by the Bank of England in August

Table 1

January 1990 Matrix

'A' Factors [Columns 1-3] 'B' Factors [Columns 4-7]

Column	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Definition	Moratorium in effect	Rescheduled at any time in the last 5 yrs or in the process of rescheduling, or has significant transfer problems and/or a limit on debt scheduling without agreement from creditors	Second or more rescheduling during the last 5 years of principal amounts rescheduled since Jan 1983, or transfer problems recorded in Column 2	Significant arrears of interest or principal to IFI's	Arrears of principal on original or rescheduled loans from other external creditors: excluding agreed arrears	Arrears of interest on original or rescheduled loans from other external creditors: excluding agreed arrears	New money following re-scheduling to clear arrears, or capitalized interest arrears, or Paris Club rescheduling of arrears
Score Range	0-3 mths - 2 4-12 mths - 4 12-36 mths - 8 >36 mths - 12	(12 for latter) 3-5 yrs - 6 2-3 yrs - 8 <2 yrs ago - 12	(12 for latter) 2-5 yrs - 6 1-2 yrs - 8 <12 mths - 12	<2yrs - 10 >12 mths - 15	0-3 mths - 4 >3 mths - 8 >12 mths - 10	0-3 mths - 4 > 3 mths - 8 >12 mths - 10	3-5 yrs - 4 2-3 yrs - 8 <2 yrs - 10
Country	2, 4, 8 or 12	6, 8 or 12	6, 8 or 12	10 or 15	4, 8 or 10	4, 8 or 10	4, 8 or 10

'C' Factors [Column 8-16]

	(8)	(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)	TOTALS	
Definition	Interest service ratio	Viable import cover	Debt/ GDP ratio	Debt/ exports goods and services ratio	Not meeting IMF targets/ unwilling to go to IMF	Unfilled financing gap over next 12 months excluding agreed arrears during restructur-ing negotiations	Market price	Highly dependent on a single source of income: commodity export, single commodity based export, service earning	Other factors	TOTAL SCORE (Max 145)	PROVIS-IONING RANGE
Score Range	>15% - 3 >25% - 5 >35% - 7 >45% - 10	<4 mths - 3 <2 mths - 5 <1 mth - 7 >0.5m - 10	>50% - 3 >75% - 5 <100% - 7 >150% - 10	>200% - 3 >300% - 5 >400% - 7 >600% - 10	3	2	<70 - 2 <50 - 4 <30 - 8 <10 - 12	2			
	3 - 10	3 - 10	3 - 10	3 - 10	3	2	2-12	2	0 to 5	TOTAL	

1987, the main difference is that the scores set up in the later matrix tend to be significantly higher, particularly for countries which are very 'uncreditworthy'. For example, factor 14 (accounting for the secondary market price) now ranges from 2-12 points; in the August 1987 matrix the range was from 2-4. As a result, it becomes easier for countries to get higher scores, and thus for higher provisioning to be required against their debts.

Scope of Application

There are two alternatives:

(i) to apply the factors and resulting provisioning percentage against all claims on a country;

(ii) to apply the factors and resulting provision percentage separately to different classes of asset.

The Bank's view is that, for supervisory purposes, the percentage provision should be applied to a bank's total exposure to, including risk transfers to and excluding risk transfers from, a particular country, unless it can be satisfied that a particular claim or class of claims will be repaid in full.

This latter decision is somewhat controversial, as it would have seemed preferable to separate trade credit (so essential to sustain trade flows) and *only* to require provisioning *if* it was not being serviced regularly.

The matrix itself is attached reflecting the new scores. It has been reported that the new matrix will imply Bank of England support for levels of provisioning averaging around 50 per cent, as compared to the levels of 30 to 35 per cent provisioning set in the earlier 1987 matrix. It has also been reported that the British Inland Revenue (the UK tax authority) will accept the Bank of England's new guidelines as *one* of the factors, when calculating allowances against tax.