

UK banks' write-offs of bad debt

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Banks' write-offs of bad debt potentially distort the statistics for lending flows and are of interest as an indicator of macroeconomic conditions. This article examines the trends and points of interest in UK banks' write-offs data. It also covers the process of adjustment to remove the effects of bad debt write-offs from the lending flows. A breakdown of UK banks' write-offs and other revaluations of loans is available in Table C2.1¹.

Introduction

When a bank determines a loan to be uncollectible the funds are classified as bad debt. The bank may choose to remove this bad debt from the asset side of their balance sheet, and this is known as a write-off. Secured debt is less likely to be written-off, as borrowers forfeit their collateral to the bank if the loan cannot be repaid.

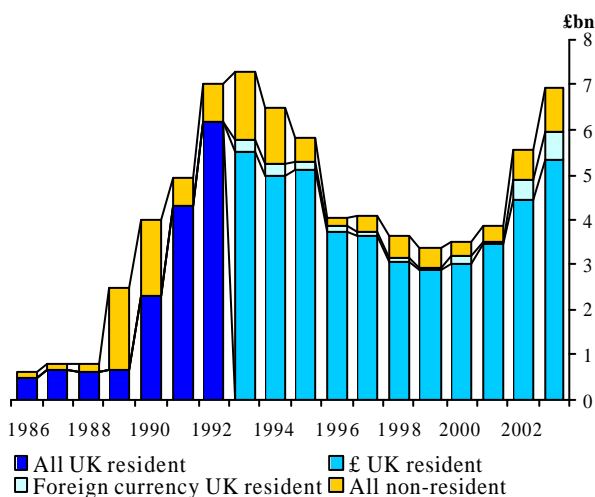
Statistics for lending flows are generally derived from changes in the amounts outstanding. As these flows should measure net new lending in any period, write-offs of previous loans, which reduce the stock of lending indistinguishably from repayments, artificially depress flows. Adjustments for write-offs are therefore applied to remove this distortion from the statistics for lending flows. An explanation of this process, and the collection of the write-offs data set, is included in the box at the end of this article.

Trends in UK banks' reported write-offs

Lending to UK Residents

Write-offs of lending to UK residents make up the vast majority of all UK banks' write-offs; an average of 82% since the data were first recorded in 1986. Data on write-offs of bad domestic debt began at the relatively low level of £0.5 billion. These low levels continued through the rapid economic growth of the late 1980s.

Chart A: UK banks' total write-offs



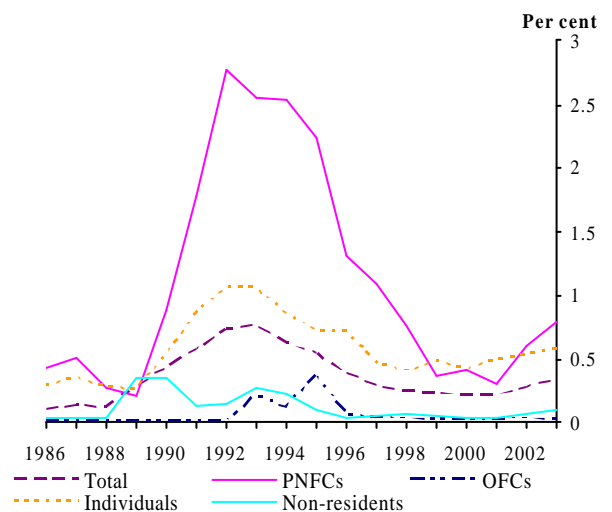
As the UK economy entered recession in the early 1990s, annual write-offs of domestic debt grew rapidly, peaking at £6.2 billion in 1992. Write-offs fell significantly in 1996, and they remained at a modest level through the remainder of the 1990s, although never reaching the low levels previously experienced. Since the millennium there has been a pick-up in write-offs of domestic loans, with the annual figure standing at £6 billion for 2003.

A currency split of domestic write-offs has been available since 1993 and shows, unsurprisingly, that the majority are denominated in sterling, with an average of 4% of all write-offs being in foreign currency. These trends can be seen in Chart A.

Annual write-offs can be seen in context when considered as a proportion of end-year loan balances. Chart B shows these annual write-off rates for all currency lending for UK banks.

The write-off rates for total lending follow a similar cyclical pattern to that seen in reported write-offs, though the recent pick-up is far less pronounced. The contrast between Charts A and B since 2000 reflects the increasing stock of lending. Absolute write-offs are approaching a peak; whereas the write-off rate is only showing gradual growth.

Chart B: UK banks' annual write-off rates



¹ For write-offs data before 1997, see article 'Adjustments for banks' bad debt write-offs' published in the 1998 Statistical Abstract and available via www.bankofengland.co.uk/mfsd/article/artabstract98.pdf

A breakdown of UK-resident banks' write-offs of loans to UK-residents by sector is available. This is illustrated in Chart C, with notable incidents picked out in the text.

Private non-financial companies

Until 1993, write-offs of lending to private non-financial companies (PNFCs) accounted for around two thirds of reported domestic write-offs. The volume of write-offs to PNFCs grew rapidly, from £0.3 billion in 1989, to a peak of £4.3 billion in 1992; while the percentage share of write-offs to PNFCs in total write-offs reached 69%. Write-offs of lending to PNFCs remained high for the next three years, including several large loans relating to the construction of the Channel Tunnel being written-down. Write-off levels fell steadily in the late 1990s, until only £0.8 billion of lending to PNFCs was written-off in 2001, accounting for 22% of total domestic write-offs. Since then there has been some resurgence in PNFCs' bad debt, with large foreign currency denominated loans to energy and telecommunications companies. As at end-2003 annual write-offs to PNFCs were £2.2 billion, accounting for around one third of total domestic write-offs.

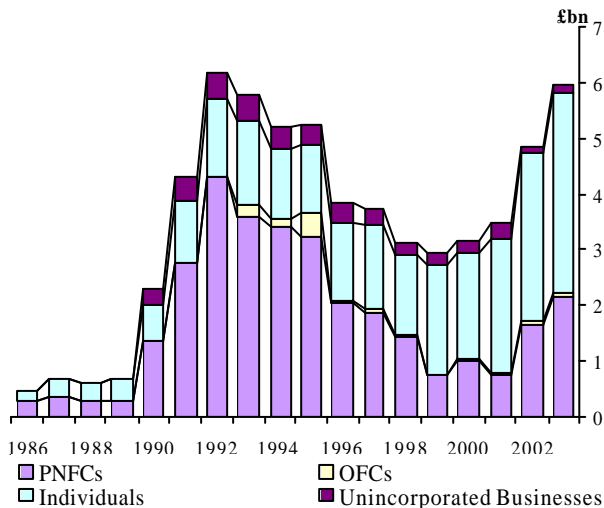
Write-off rates of lending to PNFCs have been the highest of any sector. They reached a peak of 2.8% in 1992, and remained above 2% until 1996. There followed a sharp fall in rates to 0.3% in 2001. Increases in write-offs since then have pushed the rate up to 0.8%, as at end-2003.

Other financial companies

It is rare for loans to other financial companies (OFCs) to be written-off. Write-offs to OFCs were only of note in 1995 when over £0.3 billion of loans were written-off. Since 1996 write-offs to OFCs have been negligible.

Chart B shows the write-off rate on lending to OFCs to be negligible. The exceptional write-offs in 1995 are reflected in a peak of 0.4%, but since then write-offs have fallen by 30%, while loans have increased steadily.

Chart C: Sectoral breakdown of write-offs to UK-residents



Unincorporated businesses

Write-offs of loans to unincorporated businesses (UBs), on average, account for 7.5% of domestic write-offs; entirely in sterling. This sector has seen a steady fall from £0.5 billion in 1992 to just above £0.1 billion in 2003.

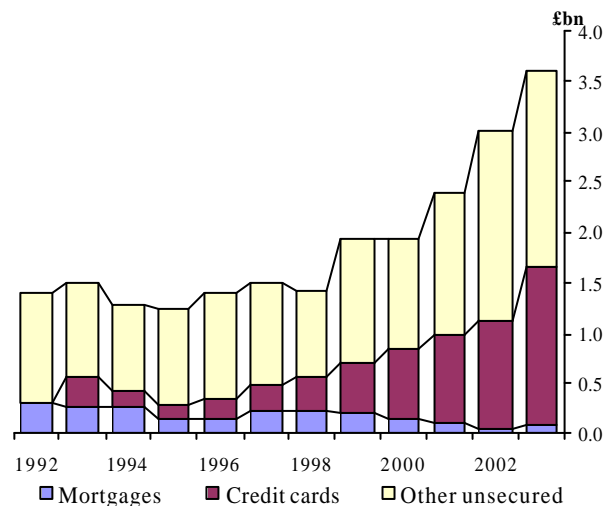
Individuals²

Write-offs of lending to individuals rose steadily between 1986 and 1993, from £0.2 billion to £1.5 billion, accounting for an average of 36% of domestic write-offs. Annual write-offs of lending to individuals remained stable through the mid-1990s. In 1997 these write-offs began to increase once more, due in part to the conversion of major building societies because virtually all of their write-offs are to individuals. Since 1999 write-offs to individuals have accounted for the greatest percentage of total write-offs. This figure stands at 61% in 2003, although this also reflects faster growth in loans to the household sector compared with loans to industrial companies.

Chart D provides a breakdown of write-offs of loans to individuals by type of loan.

Prior to 1992 all write-offs to individuals were allocated to the other unsecured debt category, while write-offs on house purchases were assumed to be negligible. Write-offs on mortgage lending began at a series high of £0.3 billion and have seen a steady decrease since then. The only notable increase occurred in 1997, following building societies' conversions (write-offs by building societies are not included in the data set, so they enter the reporting population once they convert to banks). The majority of building society lending is mortgages; therefore the majority of write-offs are on mortgage loans. The stability of this series is not surprising as mortgages are secured debt which is less likely to be written-off, as borrowers forfeit their collateral to the bank if the loan cannot be repaid. The series also reflects rising house prices, which reduce the amount of debt outstanding after property is possessed and sold, thereby reducing the amount a bank needs to write-off.

Chart D: Instrument breakdown of write-offs to individuals



² For further analysis see Section 1.1, "UK household sector credit risks", Bank of England *Financial Stability Review*, June 2004.

Write-offs of credit card debt have risen, from £0.1 billion in 1995 to £1.6 billion in 2003; although the 2003 figure includes a one-off write-off of £0.2 billion following one bank changing their accounting methodology and writing-off loans which were previously classed as non-performing. The increase has driven up the percentage of household write-offs accounted for by credit card debt from 19% in 1993 to 43% in 2003.

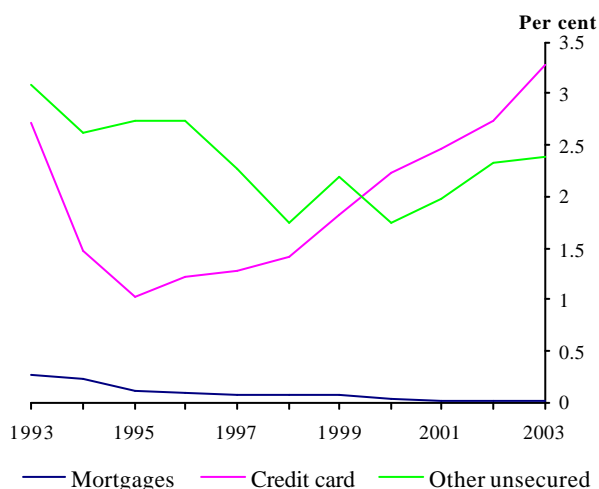
Write-offs of other consumer credit (personal loans and overdrafts) are estimated to have grown sharply at the beginning of the 1990s, then plateaued around £1 billion, before further increases in 2001 and 2002 pushed the annual figure close to £2 billion. This increase was driven by clearouts of bad debt. Despite these increases, the percentage of household write-offs attributable to other consumer credit has fallen from 78% in 1995 to 54% in 2003.

The pattern of write-off rates of lending to individuals closely resembles the picture seen in total write-off rates. A sharp increase in write-offs during the recession of the early 1990s resulted in rates of over 1%. This then fell to around 0.5% in the mid-1990s and remained stable through the rest of the 1990s. The increase in credit card write-offs has caused the rate to increase since 2000, and it stood at 0.6% at end-2003.

Chart E illustrates the annual write-off rates on sterling lending to individuals, broken down by type of loan. The growth in house prices in recent years is reflected in the annual write-off rate on mortgages, which has shown a steady decline since the start of the series and has been negligible since 2000.

The growth in credit card write-offs is stronger, with the write-off rate more than tripling since 1995, to 3.3% at end-2003. The write-off rate on other secured lending has fallen from over 3% to stabilise around 2%.

Chart E: UK banks' write-off rates on sterling lending to individuals^(a)



(a) Adjusted to reflect a bank's change in accounting method

Non-residents

Write-offs of loans to non-residents have, on average, accounted for 18% of total write-offs between 1986 and 2003 (see Chart A). A currency split has been available since 1993, and it can be seen that write-offs to non-residents are predominantly in foreign currency, with around 10% in sterling. Write-offs of loans to non-residents make up 75% of all foreign currency write-offs.

Chart A shows that write-offs to non-residents displayed a similar pattern to UK residents; low levels in the mid to late 1980s, a peak at the start of the 1990s, a modest trough in the late 1990s, and a pick up since the millennium.

The increase from low levels of write-offs in 1988 to £1.8 billion in 1989 and £1.7 billion in 1990 was largely due to write-offs of problem country debt through participation in debt reduction schemes or in the emerging secondary markets in such debt. The continued high levels of write-offs between 1993 and 1995 are connected to the issuance of several Brady Bonds. These are bonds issued as part of debt conversion deals, often by Latin American countries, as an effort to reduce the debt held by less-developed countries that were defaulting on loans. Defaulted loans were converted into bonds with U.S. zero-coupon Treasury bonds as collateral, so repayment of principal was insured. 1994 saw bonds issued for Brazil, Bulgaria, Dominican Republic and Poland, while Ecuador and Panama issued bonds in 1995.

The pick up in 1998 may reflect banks writing-off loans related to the Asian crisis. The increase continued in 2001 where there were write-offs to several non-resident companies possibly reflecting some of the fallout from September 11. Increases in 2002 and 2003 saw growth in write-offs of euro-denominated loans and lending to European non-financial companies.

The write-off rate for loans to non-residents shows peaks in 1989 and 1993, illustrating the increase in write-offs resulting from the issuance of Brady Bonds for problem country debt (See Chart B). Since the final bonds in 1996, lending to non-residents has increased strongly, while write-off levels have remained low.

Box: Write-offs data set

The method of data collection and adjustments for bad debt write-offs have evolved over time. This box describes the collection of these data and the process of adjustment to remove the effects of bad debt write-offs from the lending flows.

1986 – 1992

During this period, the Bank of England did not formally collect data from banks on write-offs of bad debt. Data were available from published sources for large British banks³, and these, along with further information from the banks themselves, were used to estimate write-offs for all banks' UK offices. These estimates were then allocated to individual economic sectors: overseas, private non-financial companies⁴, unincorporated businesses and individuals. Estimates of write-offs of lending for house purchase were made for the first time in 1992, based on additional information obtained from banks, dividing the persons category into house purchase and other. It is recognised that write-offs of lending for house purchase may have occurred in earlier years but it was not possible to split these out. These estimates of write-offs have been allocated to individual months and quarters by averaging the annual figure, and have then been added back to the flows series, calculated as the changes in amounts outstanding.

1993 – 1997

March 1993 saw the introduction of an official collection of write-offs data. The quarterly Q1(R) form collected core information on domestic and overseas write-offs, including a sectoral breakdown. Banks writing off £50 million or more in a quarter were required to complete the sectoral breakdown, whilst all banks were required to provide an annual sectorisation of the full year's write-offs to UK-residents. The monthly Q1(D) form collects data on credit card write-offs; prior to this there had been no breakdown of the consumer credit category. Data on lending for house purchase continued to be estimated, based on additional information provided by banks. The new forms also saw the first collection of data on write-offs to

other financial institutions, which in prior periods had been assumed to be small.

A formal reported split between write-offs to individuals and those to unincorporated businesses began at the end of 1994; prior to this the split had been estimated based on the banks' lending profile. The new forms also provided the first split between sterling and other currency write-offs.

To calculate the adjustments to be applied, quarterly sectoral breakdowns for those banks who had written off less than £50 million in a quarter were generated using the reported annual sectoral proportions, these were projected using the previous annual breakdown, and then revised on receipt of the current year's data. Where there were exceptional write-offs within a quarter, these were allocated to a sector separately to avoid bias. Where building societies converted to banks their write-offs were excluded when calculating the proportions for sectorisation to avoid distortion towards the individuals sector.

1997-date

Following the implementation of the Banking Statistics Review in September 1997, write-offs are reported on the new QX form. This is an expanded version of the previous Q1(R) form, collecting a greater breakdown of write-offs to individuals, including the first collection of actual data on write-offs of loans secured on dwellings. Industrial and commercial companies were formally re-classified as private non-financial corporations on this form. The method of calculating the adjustments remained very similar to before, using the sectoral splits reported in each quarter, and estimating the remainder based on the annual breakdown reported by those banks not providing a quarterly split.

Table 1: Availability of write-offs of lending series

| Write-offs series | Data Available Since | |
|--------------------------------------------|----------------------|----------|
| | Estimated | Reported |
| Total write-offs | 1986 | 1993 |
| Non-residents | 1986 | 1993 |
| UK-residents | 1986 | 1993 |
| <i>Of which</i> Non-financial corporations | 1986 | 1993 |
| Other financial corporations | n/a | 1993 |
| Unincorporated businesses | 1990 | 1993 |
| Individuals | 1986 | 1993 |
| <i>Of which</i> Secured on dwellings | 1992 | 1997 |
| Credit card | n/a | 1993 |
| Other unsecured lending | 1986 | 1993 |

³ Barclays, Lloyds, Midland and National Westminster together with Bank of Scotland, the Royal Bank of Scotland, Standard Chartered and the TSB. All data for these banks are consolidated, and taken from published sources – either the *Bank of England Banking Act Report*, the British Bankers' Association *Annual Abstract of Banking Statistics* or reports and accounts.

⁴ These were classified as industrial and commercial companies at the time.