**Box 7**

## BANK WRITE-OFFS/WRITE-DOWNS OF PRIVATE SECTOR LOANS IN THE EURO AREA

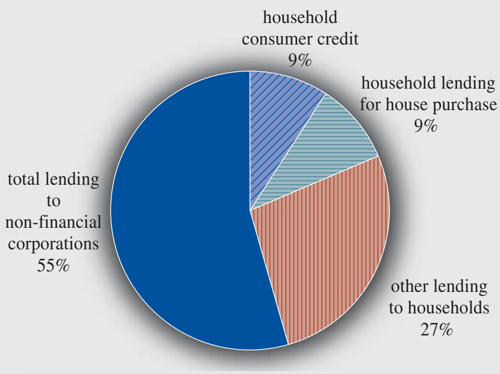
Bank write-offs/write-downs of loans (henceforth just write-offs) provide information about the creditworthiness of debtors and of losses incurred by banks in their lending.[1] So long as the information is sufficiently timely, it can help in assessing the quality of banks' assets, and therefore constitutes an additional yardstick of the soundness of the euro area banking sector. This Box reviews the nature of euro area bank write-offs vis-à-vis the private sector (households and non-financial corporations), and describes developments in recent years.

Because the final write-off of non-performing debt in MFI balance sheets may occur long after the event that caused the loan to default, write-offs can be considered a lagging indicator of the condition of private sector balance sheets. For instance, a bank may decide to maintain a potentially "bad" loan with specific provisions on its balance sheet as long as the debtor is in a position to redeem part of the loan, be it capital or purely interest. The bank is therefore likely to record a loan as "non-performing" (loans that are in arrears for some months) before it finally writes it off. It is only when the bank actually removes all or part of this bad debt from its balance sheet that the loan is deemed a write-off. In principle, write-offs can also occur in the context of securitisation activities, whereby banks sell their bad loans to third parties as a means of financial restructuring. The decision to write off a debt depends both on regulations and on corporate policies. Thus, there can be differences between banks and between countries in terms of the speed with which loans are written off. Cross-country comparisons should therefore be treated with caution.

1 A loan is written off when it is considered to be totally unrecoverable, whereas a loan is written down when it is considered to be partly unrecoverable. The ECB collects and publishes monthly data on write-offs recorded in the consolidated MFI balance sheet. These data may be found in Table 2.7 of the "Euro area statistics" section of the ECB Monthly Bulletin.

**Chart B7.1 Write-off shares by sector and by purpose in total write-offs**

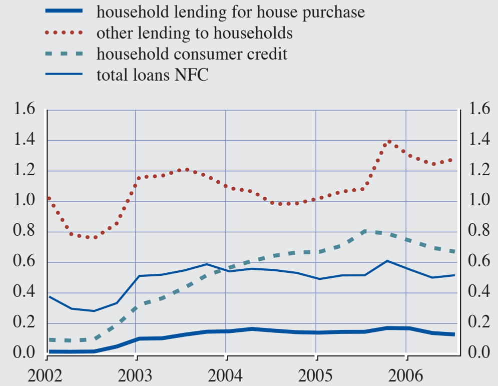
(average between Q1 2002 and Q3 2006, %)




Source: ECB.

**Chart B7.2 Write-off rates by sector and by purpose**

(four quarter moving sums, % of the outstanding amount of loans)




Source: ECB.

In the five and a half years since January 2001, the shares of write-offs in outstanding amounts of loans have been roughly evenly split between firms and households. During this period, 55% of write-offs were for loans to firms, while 45% were for loans to the household sector (see Chart B7.1). Write-off rates were higher for firms, which constituted about 45% of the total outstanding amounts to the private sector. Looking at the different categories of household borrowing, the highest amount of write-offs was on other loans.[2]

Looking at patterns over time, write-off rates on the total loan stock have remained relatively low since 2001. This mainly reflects favourable credit conditions, although it also suggests that banks had managed to contain credit losses (see Chart B7.2). Moreover, patterns have been very similar for firms and households. While write-off rates increased somewhat between 2001 and mid-2003, against a background of deteriorating economic activity, they have subsequently improved, especially after mid-2005.

**Chart B7.3 Write-off rates by original loan maturity**

(average between Q1 2002 and Q3 2006, % of the outstanding amount of loans)


Source: ECB.

The somewhat lower level of write-off rates on loans to households mainly reflects the predominance of loans for house purchase in household borrowing, the write-offs of which are traditionally the lowest among the different loan categories. This can be explained by the fact that loans for house purchase are generally collateralised, so that in the event that households struggle to service their debt, banks may still keep non-performing loans on their balance sheets, especially if the environment is characterised by buoyant housing markets. Write-off rates on loans for other purposes have been the highest, probably reflecting both a lower degree of collateralisation and the generally lower creditworthiness of borrowers in this category.

As regards loan maturity, the highest write-off rates have been for short-term loans with maturities of up to one year both for households and firms (see Chart B7.3).[3] This may reflect the fact that banks have a tendency to limit the maturities of riskier loans, and that short-term loans are typically less collateralised than long-term ones.

To conclude, write-off rates have remained at fairly low levels in recent years, partly reflecting the very low levels of interest rates that have facilitated debt servicing by the private sector. In recent years, house prices have increased significantly in a number of euro area countries and corporate profits have been strong. While write-off rates have generally started to decline since mid-2005, an upturn cannot be excluded in the period ahead, given recent rises in short-term interest rates. Moreover, if house prices were to decline and/or if re-leveraging by firms were

2 "Other loans to households" are defined as "loans granted for purposes such as business, debt consolidation, education, etc." (Regulation ECB/2001/13), which also includes loans to non-profit institutions and sole proprietorships.
3 The maturity breakdown should be considered with some caution as full information about the distribution across maturity categories is not always available. Consequently, in some cases mechanical criteria for computing the breakdown of write-offs by maturity have been applied.

to prove unsustainable, a rise in write-off rates could be expected. Overall, their timeliness and detailed breakdowns by sector, purposes and maturity mean that these data can provide useful information about the vulnerability of households and firms and the losses incurred by MFIs. Being a backward-looking indicator, however, write-off rates should be assessed in parallel with other indicators of credit risk with regard to the banks’ loan portfolios.