Box 2

DEVELOPMENTS IN BANKS' LOAN-LOSS PROVISIONS OVER RECENT YEARS

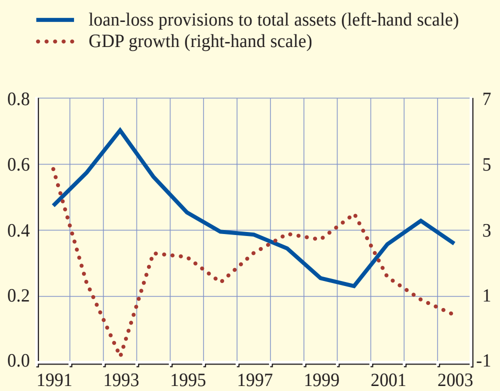
Banks play a key role in the monetary policy transmission process on account of their central position in the euro area financial system. This implies that changes in the financial situation of banks can have important implications for the smoothness of the monetary policy transmission process and can signal potential risks to financial stability.

The degree of loan-loss provisioning is an important quantitative indicator for assessing the health of the banking sector. Normally, banks should set aside loan-loss provisions to take account of the likelihood that some loans may not be repaid in full. In practice, in most euro area countries, accounting provisions are typically made once the loan has genuinely become impaired, for instance when interest payments have been missed. As a consequence, on a macroeconomic level, provisioning for most bad loans does not normally increase significantly until cyclical downturns have already set in. This in turn implies that provisioning often magnifies the impact of the economic cycle on banks' income and capital.

This box reviews loan-loss provisioning trends in the euro area since the early 1990s. It is important to bear in mind the diverse country regulations and management practices relating to the accounting of these provisions. Taking this into account, Chart A shows that the ratio of loan-loss provisions to total bank assets increased after 2000 against the background of the slowdown in economic activity in the euro area.

Chart A Loan-loss provisions to total banks' assets and GDP growth

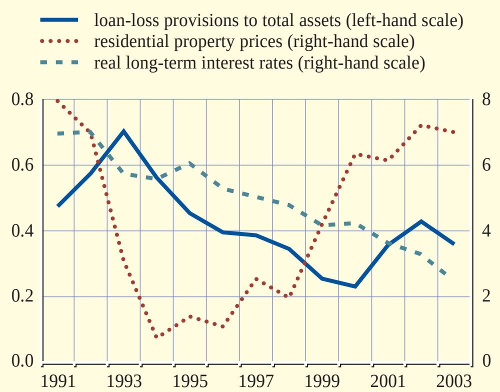
(percentages of total banks' assets; annual percentage changes)



Sources: Bankscope, Eurostat, OECD and ECB calculations.
Note: Loan-loss provisions data for 2003 have been inferred from data of the largest 50 banks for the first half of 2003.

Chart B Loan-loss provisions to total banks' assets, residential property prices and real bank long-term interest rates

(percentages of total banks' assets; annual percentage changes; percentages per annum)



Sources: Bankscope, Eurostat, OECD and ECB calculations.
Note: Euro area residential property prices calculations are based on non-harmonised data. Estimations for 2003 are calculated using available data for the first quarter of 2003. Real long-term interest rates data are retail bank interest rates on loans to households for house purchase available until September 2003 deflated by annual HICP inflation. Loan-loss provisions data for 2003 have been inferred from data of the largest 50 banks for the first half of 2003.

However, putting the recent upturn into a longer-term perspective, loan-loss provisions in recent years have remained significantly below the heights reached in the early 1990s. The recent economic slowdown has been milder than the previous slowdown in the early 1990s. This in turn has helped to contain loan-loss provisions. In addition, the household sector seems to have been much more resilient through the recent downturn than it was ten years ago, partly because labour market conditions have not deteriorated to the same extent as in the 1993 recession.

The pronounced rise of house prices in most euro area countries also contributed to containing loan-loss provisions (see Chart B). Recent developments in euro area residential property prices contrast with those in the early 1990s when house price increases were lower. By raising the value of the collateral of mortgage loans, increases in house prices supported household balance sheets in the latest cyclical downturn.

The low level of interest rates also helped to dampen loan-loss provisions (see Chart B). Despite increases in the financial leverage of households and corporations in recent years, the low level of interest rates has contained the interest rate burden of borrowers. As a result, borrowers have faced fewer difficulties servicing their debt than in the early 1990s. Consequently the needs of banks to provision against bad loans have been more modest.

Finally, several structural factors also seem to account for somewhat lower loan-loss provisioning than in the slowdown of the early 1990s. These include the use of better risk management techniques by banks and the availability of better opportunities for the largest banks to offload part of their credit risks, either via securitisation or by using credit derivatives.[1] As a consequence, the rather small increases in loan-loss provisions in the recent economic downturn seem to reflect a confluence of structural improvements in the banking sector as well as a combination of more favourable cyclical developments.

1 See the Report entitled "EU Banking Sector Stability", prepared by the Banking Supervision Committee of the European System of Central Banks, ECB, November 2003.