Box 6

NATURE OF AND DEVELOPMENTS IN WRITE-OFFS/WRITE-DOWNS OF HOUSEHOLD LOANS IN THE EURO AREA

As part of a broad assessment of monetary and credit conditions, it is interesting to consider banks' write-offs and write-downs of loans (hereafter referred to jointly as write-offs).[1] First, they provide information on how the gross and net lending flows recorded in the consolidated MFI balance sheet which underlies the monetary data are reconciled. Second, they may provide an indication of debtors' financial conditions. The ECB regularly publishes write-offs in Table 2.7 of the "Euro area statistics" section of its Monthly Bulletin. This box reviews the nature of these data for the household sector and describes their developments in recent years.

Write-offs are typically a lagging indicator of financial conditions in the household sector. The final write-off of non-performing debt in the MFI balance sheet may occur long after the event that caused the loan to default. 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

1 A loan is written off when it is considered to be totally unrecoverable, while a loan is written down when it is considered to be partly unrecoverable.

securitisation activities, whereby banks sell off their bad loans to third parties as a mean of financial restructuring. The decision to write off a debt depends on both regulations and 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.

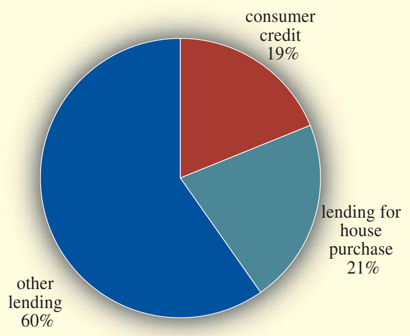
The breakdown of write-offs by the different categories of household borrowing, namely lending for house purchase, consumer credit and other lending, is quite different to the breakdown of outstanding amounts of loans to households by the same categories. In March 2006 lending for house purchase accounted for 70% of the outstanding amount of total loans to households, followed by other lending (17%) and consumer credit (13%). By contrast, as shown in Chart A, write-offs of other lending account for the largest share of write-offs of MFI loans to households, at around 60%, followed by write-offs of lending for house purchase (21%) and write-offs of consumer credit (19%).

In the period since 2001 (for which these data are available), write-offs have been relatively small in relation to the loan stock. Chart B shows the annual sum of write-offs as a percentage of the outstanding amount of loans, displaying clear differences in the level and the pattern of write-off rates across household loan categories.[2] The write-off rate for total loans increased somewhat between 2002 and mid-2003 but has since remained fairly stable at around 0.4%. This reflects to a large extent the pattern of write-off rates for lending for house purchase, which have remained fairly stable since 2004 and are the lowest among the different loan categories. This can be explained by the fact that loans for house purchase tend to be collateralised and banks may thus tend to keep non-performing loans on their balance sheets, especially in

2 The cumulative annual sums conceal the clear seasonal pattern in write-offs, with peaks at the end of each calendar year. This may be related to accounting practices whereby banks use their discretion to record write-offs in the context of compiling their annual accounts, often around the turn of the year, for subsequent approval by shareholders.

Chart A Breakdown of write-offs by loan category

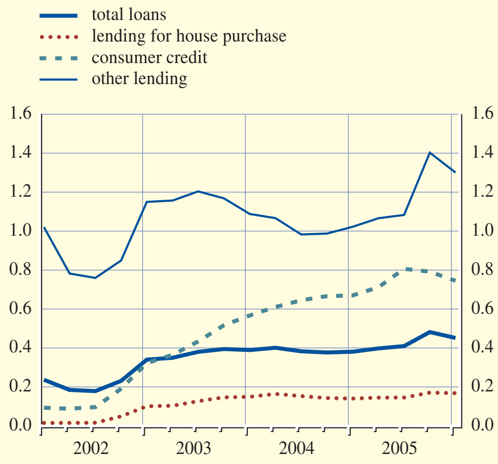
(cumulative data for January 2001-March 2006)



Source: ECB and ECB calculations.

Chart B Annual write-off rates

(cumulative annual rates as a percentage of the respective amounts outstanding at the beginning of the period; quarterly data)

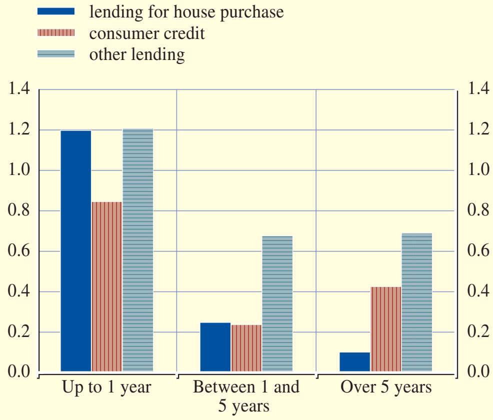


Source: ECB and ECB calculations.

an environment of strong house price dynamics. The write-off rate for consumer credit has shown a steady increase since 2002, possibly reflecting the strong growth in consumer credit in the period 1999-2000 and subdued income growth in recent years. The write-off rates for other lending are far higher than the rates for the other categories, and display a more volatile pattern.

Chart C Write-off rates by original loan maturity

(as a percentage of the outstanding amount of loans; average ratio between December 2001 and March 2006)



Source: ECB and ECB calculations.

By international standards, the write-off rates for lending to households reported in this box are somewhat lower than those reported for the United Kingdom and the United States, although it has to be borne in mind that the numbers may not be fully comparable due to conceptual differences. For instance, since 2001 annual write-off rates for lending to individuals in the United Kingdom (excludes data for unincorporated businesses) have, on average, been around 0.6%, compared with around 0.3% in the case of the euro area.[3] Data for the United States show an average rate of somewhat less than 0.2% ("charge-off rate", reported as annualised percentages of outstanding amounts) on mortgage loans in the period since 2001, while in the case of the euro area the average write-off rate for loans for house purchase in the same period is 0.1%. At the same time, the US rate for consumer credit stands at around 2.8% for the period since 2001, compared with a write-off rate of slightly less than 0.5% in the case of the euro area.[4] This might be a reflection of the more pervasive use of credit card debt in the United States.

As seen in Chart C, the highest write-off rates are recorded for short-term loans with a maturity of up to one year. This may reflect both economic and statistical factors. On the one hand, banks may have a tendency to limit the maturities of riskier loans. On the other hand, write-off data are as yet only available for five years, which may not fully reflect the amount of loans issued in the lending boom of 1999-2000 with an original maturity of more than five years that have become bad loans.

To conclude, while write-off rates have remained low in recent years, it should be borne in mind that interest rate levels have also been very low, thus facilitating debt servicing. Moreover, in a number of euro area countries house price developments have been very dynamic and may have led to fewer write-offs. This implies that write-off rates might be sensitive to rising interest rates or declining house prices. Close monitoring of these data as a useful indicator of the vulnerability of households and their creditors is warranted.

3 Excluding write-offs for "other lending", as a rough proxy for unincorporated businesses, the euro area write-off rate would have been around 0.2% for the same period.
4 See the Federal Reserve System's website (http://www.federalreserve.gov/releases/chargeoff/chgallnsa.htm).