Box 11

## ESTIMATE OF POTENTIAL FUTURE WRITE-DOWNS ON SECURITIES AND LOANS FACING THE EURO AREA BANKING SECTOR

This box provides an update of the estimate of potential write-downs for the euro area banking system, applying the same methodology that was used in past issues of the FSR.[1] After the finalisation of the December 2009 FSR, securities prices continued to rise and CDS spreads on structured credit securities continued to tighten, contributing to a lowering of the marked-to-market loss rates implied by the prices and spreads of these securities. Against this background, compared with the figures presented in the December 2009 FSR, the estimate of total potential write-downs on securities for the period from 2007 to 2010 has been reduced by €43 billion to €155 billion (see Table A). Furthermore, since the write-downs on securities that had been reported by euro area banks at the time of writing exceeded the write-downs implied by prevailing market prices, it cannot be excluded that some write-backs on securities classified as "available-for-sale" or "held-for-trading" may be recorded by some banks in the period ahead. These potential write-backs could be as high as €32 billion and this would be reflected in higher profits on securities classified as "held-for-trading", or in lower reserves for securities held in the "available-for-sale" category. In both cases, it could generate capital relief for the banks who benefit.

Considering the outlook for loan losses, although the euro area macroeconomic environment improved somewhat after the finalisation of the December 2009 FSR, it continued to be clouded by uncertainty. In particular, unemployment rates remained at elevated levels in some countries and are expected to rise further in some cases. Moreover, as indicated in Section 2.3, conditions in commercial property markets remain challenging. Against this background, compared with the figures published in the December 2009 FSR, the estimated write-downs on residential mortgages and corporate loans have decreased slightly, while potential write-downs on consumer loans and commercial property loans have increased. Overall, the total estimate of potential write-downs on loans for the period from 2007 to 2010 has been increased by €5 billion to €360 billion.

1 See Box 14, entitled "Estimating potential write-downs confronting the euro area banking sector as a result of the financial market turmoil", in ECB, *Financial Stability Review*, June 2009, and Box 10, entitled "Estimate of potential future write-downs on securities and loans facing the euro area banking sector", in ECB, *Financial Stability Review*, December 2009.

**Table A Potential write-downs on securities and loans for the euro area banking sector over the period from 2007 to 2010**

(EUR billions)

| | Cumulative implied write-downs | | Estimated loss rate (%) | |
|---|---|---|---|---|
| | December 2009 FSR | June 2010 FSR | December 2009 FSR | June 2010 FSR |
| **Cash and synthetic structured credit securities** | | | | |
| Residential mortgage backed securities (RMBSs) | 55.7 | 56.0 | 12.5 | 11.5 |
| Asset-backed securities (ABSs) | 3.6 | 2.6 | 1.9 | 1.4 |
| Collateralised debt obligations (CDOs) backed by ABSs/RMBSs (all tranches) | 83.6 | 68.2 | 57.7 | 54.3 |
| Commercial mortgage-backed securities (CMBSs) | 20.2 | 13.1 | 25.6 | 17.3 |
| Collateralised loan obligations (CLOs) | 5.7 | 0.0 | 2.5 | 0.0 |
| Asset-backed commercial papers (ABCP) | 0.2 | 0.2 | 1.7 | 1.7 |
| Corporate CDOs | 0.3 | 0.3 | 1.7 | 1.7 |
| **Total for cash and synthetic structured credit securities** | **169** | **140** | **15.1** | **13.4** |
| **Other security holdings** | | | | |
| Corporate debt securities | 6.2 | 0.0 | 2.4 | 0.0 |
| Covered bonds | 0.0 | 0.0 | 0.0 | 0.0 |
| Bank bonds | 0.0 | 0.0 | 0.0 | 0.0 |
| Equitiy holdings | 3.8 | 0.0 | 2.4 | 0.0 |
| Securities issued in central, eastern and south-eastern Europe | 12.8 | 10.5 | 4.9 | 4.0 |
| Other securities | 5.6 | 3.9 | 2.4 | 2.5 |
| **Total for other security holdings** | **28** | **14** | **1.6** | **0.8** |
| **Total for all securities** | **198** | **155** | **7.0** | **5.5** |
| **Loans to non-financial customers** | | | | |
| Residential morgages | 44.3 | 37.2 | 1.2 | 1.2 |
| Consumer loans | 63.8 | 70.1 | 4.3 | 5.6 |
| Commercial property mortgages | 37.7 | 55.3 | 4.8 | 5.8 |
| Corporate loans | 193.5 | 190.1 | 3.8 | 3.2 |
| Syndicated loans | 15.7 | 7.5 | 4.4 | 2.9 |
| **Total for all loans** | **355** | **360** | **3.1** | **3.2** |
| **Total potential write-downs on securities and loans** | **553** | **515** | **3.9** | **3.6** |
| Write-downs reported to end-October 2009 (December 2009 FSR) and end-April 2010 (June 2010 FSR) | 180 | 187 | | |
| Possible write-backs due on securities | - | -32 | | |
| Loan loss provisions 2007-H1 2009 (December 2009 FSR) and 2007-end-2009 (June 2010 FSR) | 186 | 238 | | |
| Potential further write-downs on loans in 2010 | - | 123 | | |
| **Potential further net write-downs on securities and loans** | **187** | **90** | | |

Sources: Association for Financial Markets in Europe, Banking Supervision Committee, national central banks, ECB and ECB calculations.

According to the consolidated banking statistics and an estimate based on figures reported by a sample of euro area LCBGs between 2007 and 2009, euro area banks made provisions of €238 billion for the deterioration in the quality of their loan exposures. This means that euro area banks may need to provision for an additional €123 billion in loan losses in 2010.

Overall, taking the outlook for possible future write-downs on loans together with an outlook for possible write-backs on securities, potential further net write-downs of around €90 billion on loans and securities could be suffered by euro area banks in 2010. Should core earnings and net profitability before provisioning remain at the levels observed over the past few years, the assessment is that euro area banks should not be confronted with major problems in absorbing these additional write-downs.

**Table B Potential write-downs on loans for the euro area banking sector in 2011**

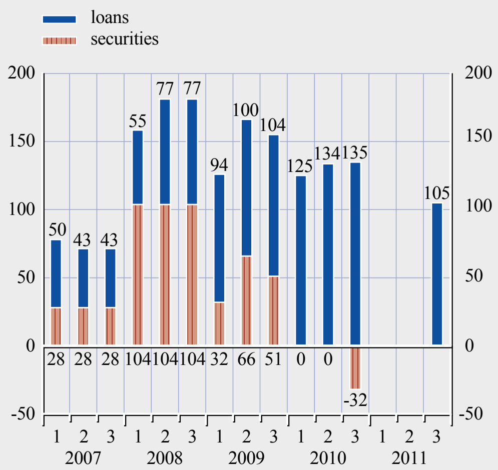
(EUR billions)

| Loans to non-financial customers | Cumulative implied write-downs | Estimated loss rate (%) |
|---|---|---|
| Residential mortgages | 13.6 | 0.4 |
| Consumer loans | 25.7 | 1.7 |
| Commercial property mortgages | 16.1 | 2.1 |
| Corporate loans | 48.5 | 0.9 |
| Syndicated Loans | 1.5 | 0.4 |
| **Total for all loans** | **105** | **0.9** |

Sources: Association for Financial Markets in Europe, Banking Supervision Committee, national central banks, ECB and ECB calculations.

**Potential write-downs on securities and loans facing the euro area banking sector**

(EUR billions)




1 June 2009 FSR
2 December 2009 FSR
3 June 2010 FSR

Sources: Association for Financial Markets in Europe, Banking Supervision Committee, national central banks, ECB and ECB calculations.

Applying the same methodology as in previous assessments and using forecasts for macroeconomic variables in 2011, an estimate of the potential further write-downs on loans to be recorded by euro area banking sector in 2011 can also be made.[2] According to this estimate, euro area banks would need to make additional loan-loss provisions of around €105 billion in 2011 (see Table B). Given the uncertainties related to the modelling approach and the underlying assumptions, however, some caution is warranted when interpreting this figure.[3] Moreover, heightened sovereign risks and possible second-round effects of the fiscal consolidation that is necessary in most euro area countries could pose some downside risks to economic growth in the euro area. Should these risks materialise, loan-loss provisions would most likely be higher in the period ahead. Also, the assumption made in the analysis that there would be no further write-downs on securities exposures is conditional on the sustainability of the past recovery in securities prices. All in all, the upside risks to the estimate of potential future write-downs seem to exceed the downside risks.

Regarding the distribution of losses by type of exposure over time, write-downs on securities exposures contributed significantly to losses and capital drains in 2008 and 2009. Going forward, while the recovery in securities prices makes valuation write-backs likely in 2010, write-downs on loans are expected to remain relatively high (see the chart above). However, banks should largely be able to forecast the loan losses using their internal models, and the scope for unexpected capital shortages is therefore rather limited.

2 Given that securities prices indicate that no further write-downs on banks' securities portfolios are imminent, potential write-downs on securities in 2011 are not considered in the analysis.
3 These uncertainties are related, among other things, to the scope and distribution of banks' exposures to securities, the accuracy of model forecasts, differences in accounting rules in some euro area countries and the adequacy of assumptions about the economic environment.