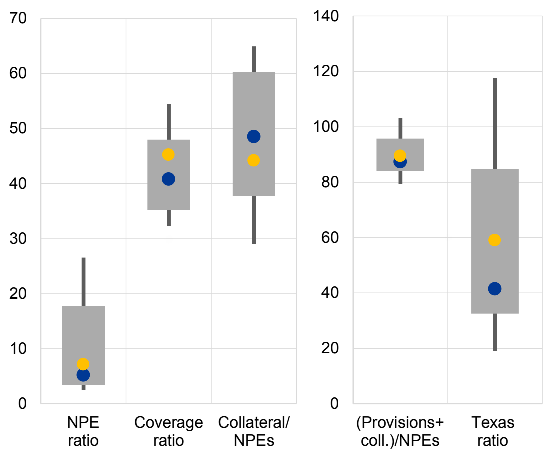
Box 5
Latest indicators of euro area bank asset quality

Chart A
NPE ratios remain at rather elevated levels in euro area countries most affected by the financial crisis, although credit risk is partly mitigated by higher collateralisation

Distribution of country-level asset quality ratios in the euro area

(Q4 2015; percentages; median (blue), weighted average (yellow), 10th and 90th percentiles and interquartile range)



Sources: ECB and ECB calculations.
Note: Based on country aggregates calculated for significant institutions.

Euro area banks' asset quality has remained in the focus of both supervisors and market participants as banks' balance sheets in some countries are still burdened with a high level of non-performing exposures (NPEs). Large public disclosures, including those associated with the ECB's comprehensive assessment and the European Banking Authority (EBA) 2015 transparency exercise, have helped to clarify the nature and extent of these NPEs. While euro area banks' solvency positions have improved significantly over the past few years, the NPE overhang remains a drag on banks' profitability and weighs on their ability to extend new loans. Against this background, this box presents an updated overview of the scale of the NPE problem in the euro area based on the latest supervisory data on NPEs, provisioning and collateral, and it also discusses some structural features that affect the speed of NPE resolution.

Euro area banks' NPE ratios remain elevated by international comparison and the high level of NPEs continues to be a key challenge for the financial system. Euro area significant institutions held nearly €950 billion of NPEs at the end of 2015, equivalent to about 9% of euro area GDP. Euro area significant institutions' average NPE ratio, at 7.1%, is high by international standards and clearly exceeds those of US and UK peers.[23] NPE ratios vary widely across the euro

[23] The average non-current loan ratio (a proxy for the NPE ratio) of US banks stood at 1.5% at the end of 2015, while the average NPE ratio of UK banks participating in the EBA transparency exercise was 3.2% (based on data for the first half of 2015).

area, but remain at rather elevated levels in the majority of vulnerable countries. Within this country group, the median NPE ratio stood just below 20% at end-2015, but this group of countries itself is heterogeneous as indicated by a wide interquartile range between 18% and 34%.

The coverage ratio, as measured by loan loss reserves as a proportion of NPEs, stood at 45% on average for euro area significant institutions, but with considerable variation across countries. In some high NPE countries, provisioning levels remain at or even below the euro area average. Relatively low coverage ratios in these countries can be an impediment to more effective NPE resolution as they can contribute to wide pricing gaps between potential buyers and sellers of NPEs.

Relatively low provisioning coverage in some high NPE countries may partly reflect the higher collateralisation of loans and NPEs. The average ratio of collateral and guarantees to NPEs for euro area significant institutions was 44% at end-2015, although with significant differences across countries (see left-hand panel of Chart A). Countries that record high NPEs typically have a relatively high ratio of collateral and financial guarantees to NPEs, where collateral represents a much higher share than guarantees. The broad coverage ratio adjusted for collateral and guarantees on average stood at around 90% at end-2015, with the majority of vulnerable countries recording above-average values. At the same time, weak debt enforcement frameworks in some high NPE countries raise the cost of debt recovery and lengthen the time needed to repossess collateral.

Asset quality in the United States is often assessed by the so-called Texas ratio. The Texas ratio is a simple metric of bank balance sheet health which compares problem loans with the financial resources a bank has to absorb (further) losses from its troubled assets. It is typically defined as gross non-performing loans (NPLs) over tangible equity and loan loss reserves. The average Texas ratio for euro area significant institutions stood just below 60% at the end of last year, with some countries recording values above 100% (see right-hand panel of Chart A). Euro area banks' average Texas ratio is well above both the current level for US banks (below 10%) and the value measured in the first quarter of 2010 (31%) when NPL ratios peaked in the United States.

The persistence of high NPEs in the euro area, which stands in stark contrast to the rapid resolution of NPEs in the United States, partly reflects different structural features between the two regions and the relatively greater obstacles to effective NPE resolution in the euro area.[24] First, the important role of government-sponsored entities (GSEs) in the US mortgage market[25] implied that a significant part of residential mortgage-related NPLs were booked outside banks' balance sheets. Second, regulatory requirements that provide an overlay to accounting standards in the United States oblige banks to write down loans to the recoverable value of collateral after six months as well as to suspend interest income on NPLs once the loan is 90 days past due. By contrast, accounting standards in the European Union tend to lengthen write-offs or

24 For a detailed overview of obstacles to effective NPE resolution in EU countries, see *Financial Stability Review*, ECB, May 2015, Special Feature C.

25 In 2009 the two large GSEs (Fannie Mae and Freddie Mac) owned or guaranteed roughly half of all outstanding mortgages in the United States (including a significant share of sub-prime mortgages).

provide a disincentive to remove NPLs from the balance sheet.[26] Third, the unfavourable tax treatment of loan loss provisions and write-offs in several EU countries (e.g. tax deductions for loan loss provisions and write-offs have been or are still subject to a cap) provides a disincentive for quicker loan loss recognition and write-offs.[27] Fourth, the prevalence of non-recourse mortgages in many US states creates additional incentives for the timely resolution of NPLs. Finally, despite some recent pick-up in NPL disposals to third-party investors, the distressed debt market in the European Union remains small compared with that in the United States.

High levels of NPEs continue to be a key macroprudential concern in the euro area and progress in NPE resolution remains slow. However, in addition to harmonised data on NPE and coverage ratios, data on the collateral and guarantees behind these NPEs are important to assess asset quality figures. This latter information is a useful complement given the structural features of euro area banks' loan books, though it should be acknowledged that the lengthy and complex process to repossess collateral in some euro area countries may have negative implications for the recovery value of NPEs and collateral. Furthermore, the comprehensive analysis of asset quality problems should also account for structural factors that affect the speed of NPE resolution. In particular, the international comparison of asset quality indicators needs to be made with care given the important differences in features notably of an accounting, supervisory (provisioning and write-off rules), fiscal and structural nature. This also highlights the need for further progress in strengthening the operational environment for NPE resolution at both the country and European levels.

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26 For instance, International Financial Reporting Standards (IFRS) do not provide detailed guidance on write-off rules which in some cases forces banks to follow the stricter rules for loan cancellation, thereby lengthening the process of removing NPLs from the balance sheet. Furthermore, the accounting treatment of interest income allows banks to recognise interest on certain categories of NPLs, thereby providing a disincentive for resolving NPLs. Looking ahead, IFRS 9 (to be implemented from 2018) will include a clear definition of write-off that is different from loan cancellation. Under IFRS 9, banks are expected to write off loans earlier, opening the way for possible corporate restructuring or liquidation.

27 In this respect, the implementation of IFRS 9 from 2018, where the accounting treatment of impairments is based on the expected loss principle, will help overcome some of these issues.