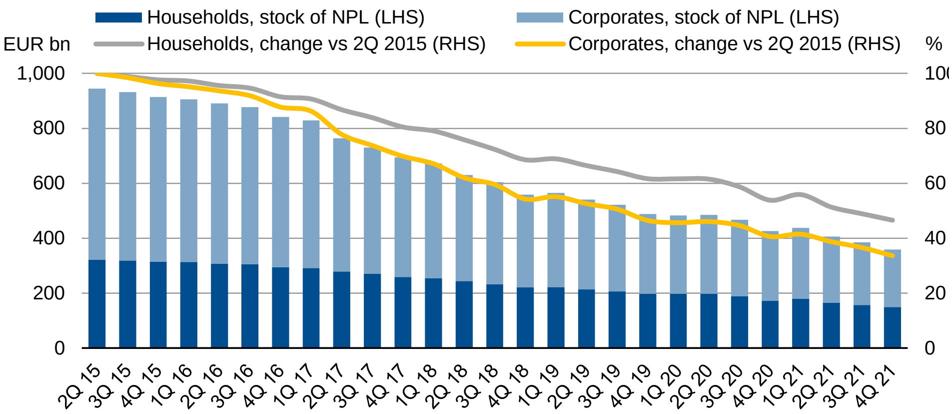
Asset Quality Review: do rising interest rates mean rising NPLs for European banks?

Tightening financial conditions in Europe will reverse the downtrend in non-performing loans (NPLs). Moves to raise interest rates come at a time of worsening GDP growth prospects while supply-chain issues and inflationary pressures are squeezing corporate profit margins and household disposable income. Still, we believe a number of factors will mitigate negative impacts on the creditworthiness of European banks:

- The massive clean-up of banks' balance-sheets in recent years has created room to absorb an increase of NPLs. The stock of NPLs at large European banks has fallen by over 60% since 2015 to EUR 373bn from about EUR 1trn. The reduction in corporate NPLs has been huge but retail NPLs have also halved (Figure 1). This is an element of credit strength. Beyond this generally positive trend, however, pockets of new and legacy risks remain.
- The trend reversal will be gradual due to the lag between worsening economic conditions and NPL recognition. Changes are not yet visible based on banks' most recent figures. Cost of risk for the large European banks in the first quarter was moderate, generally below the 2019-2021 average, except for banks most exposed to Ukraine and Russia. Delays in the NPL trend reversal offer more time for proactive measures.
- Rising interest rates will support banks' revenues and ultimately their ability to absorb potentially higher credit losses. But while balance-sheet repricing should be positive, tighter credit conditions will trigger a reduction in credit demand, limiting upside for banks.
- Creating an efficient mechanism for banks to offload NPLs through portfolios sales and securitisation has been vital. This has been a key driver of the massive reduction in NPLs and it remains a policy priority for EU authorities. As such, rising NPLs will not necessarily mean higher NPL ratios for European banks.

Figure 1: Non-performing loans at largest European banks



Significant institutions directly supervised by the ECB.
Source: ECB supervisory banking statistics, Scope Ratings

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Risk of NPL formation has materially increased.

Succession of unresolved pressure points

For banks, emerging risks are adding to the vulnerabilities identified before and during the pandemic, even if specific credit risks have not as yet materialised. The accumulation of pockets of risks is a concern. We highlight the following drivers:

- **New cohorts of vulnerable borrowers will emerge as interest rates increase**. Higher rates will impact all borrowers but will be especially detrimental to the most fragile. The adjustment of banks' origination criteria and pricing will weigh more heavily on marginal borrowers. This is likely to have a pro-cyclical effect on asset-quality metrics. Spread widening among sovereign and corporate issuers is already a reality. For sovereigns, more expensive refinancing conditions could limit their capacity for fiscal intervention. The ECB is committed to preventing fragmentation. The effectiveness of the interest-rate hedges of financial and non-financial corporates will also be tested.
- **The prolonged period of abundant liquidity and low interest rates has increased the risk of a damaging correction in some sectors**. The ECB has warned repeatedly about the growing risks in leveraged finance. Other sources of vulnerability relate to the continuing increase of credit to the private sector, rising property prices stretching affordability, and volatile equity markets. A comforting element has been the parallel growth of cash and deposits, but wealth accumulation has been uneven.
- **Since the end of February, efforts to identify vulnerabilities have focused on direct credit exposure to Ukraine and Russia**. Direct exposure is manageable but understanding which counterparties are exposed to the indirect effects of the war or to the evolving regime of sanctions is unclear.
- **New vulnerabilities are emerging for sectors and borrowers most exposed to inflationary pressures**, for instance in relation to energy prices, food and other raw materials. The pressure is not contained to specific sectors, making it more challenging to quantify the impacts.

As macro risks spread, containing credit risk will be tough

Time to predict an NPL tsunami again?

After the macroeconomic shock triggered by the Covid-19 pandemic, many market participants feared a tsunami of NPLs, taking them back above the EUR 1trn mark.

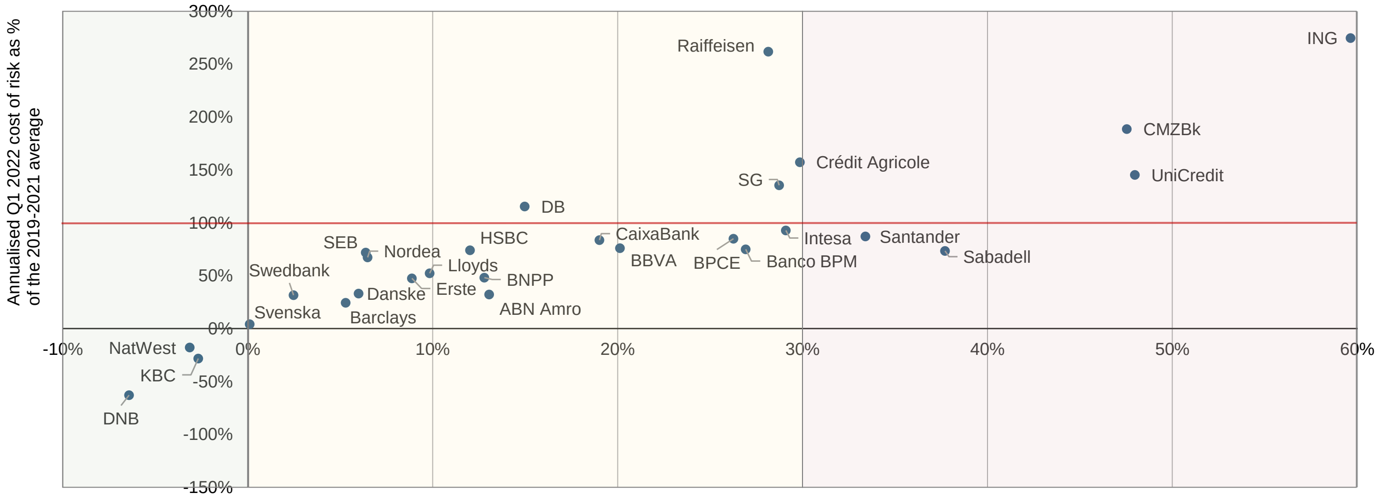
Thanks to huge public-sector support during the pandemic followed by a solid economic rebound, the trend to lower NPLs did not reverse; there was not even a slowdown in the decline of on-balance sheet NPEs (Figure 1). This can be also attributed to the material post-GFC de-risking of European banks' business models, which included significant upgrades to risk management practices and procedures.

Trend reversal not yet visible; the starting point is comforting

Cost of Risk under control

A potential reversal of the trend in NPL formation will take time to materialise. It was not visible at the end of the first quarter for our sample of 30 large European banks. Cost of risk for the large European banks was moderate in the first quarter and was generally below the 2019-2021 average, except for banks most exposed to Ukraine and Russia (Figure 2). A few banks have been reversing provisions. Cost of risk has been impacted by efforts to maintain or strengthen overlays due to the deteriorating economic outlook, not because of a material increase in specific files defaulting. There is more to come in the second quarter, notably Societe Generale recording of the sale of its banking and insurance activities in Russia.

Figure 2: Cost of risk and pre-impairment capacity of large European banks

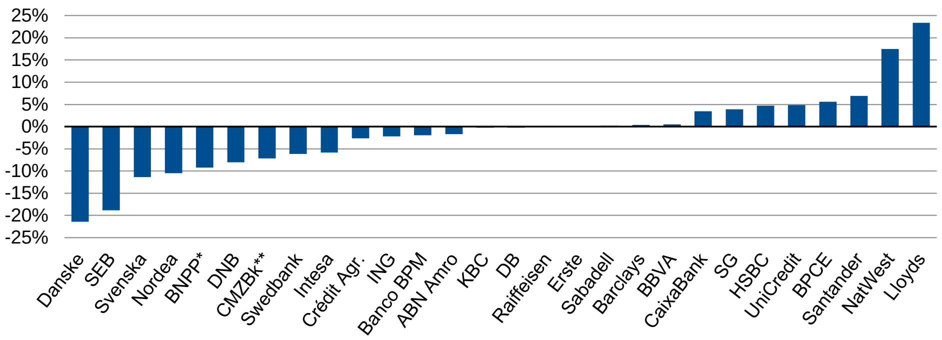


Source: SNL, banks, Scope Ratings

No widespread increase in NPLs in Q1 2022

Another comforting element so far is the benign growth of Stage 3 loans (Figure 3). In our sample, the largest increases of Stage 3 loans at the end of the first quarter were seen at UK banks because of the adoption of a new definition of default, mainly in relation to consumer loans and at Santander (also in relation to the new definition of default, and exposures outside of Europe). For most banks, the stock was stable or even decreased e.g. Danske Bank also due to the adoption of the new definition of default.

Figure 3: Stage 3 loans at large European banks in Q1 2022

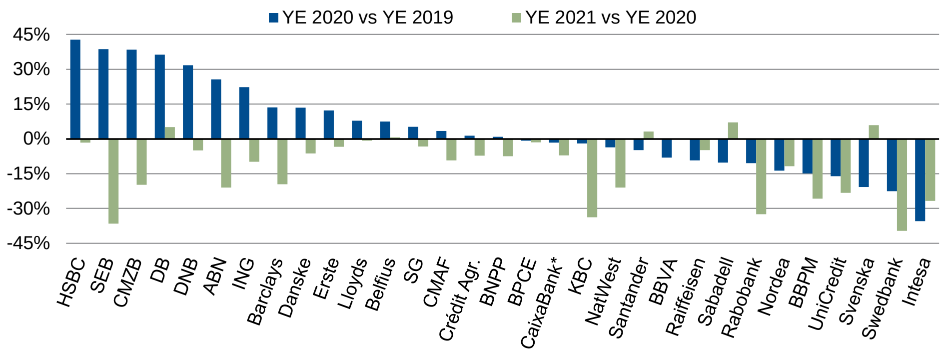


*Change in the stock of Stage 3 loans in 1Q 2022 versus 4Q 2021. *BNPP: change in doubtful loans as reported by the bank. **CMZBk: change in non-performing exposures, as reported.* Source: SNL, banks, Scope Ratings

Resilient Q1 figures in line with the positive trend observed in 2021

While growth in Stage 3 loans was balanced in 2020, the trend was positive across the board in 2021 as most large European banks reported lower Stage 3 loans (Figure 4).

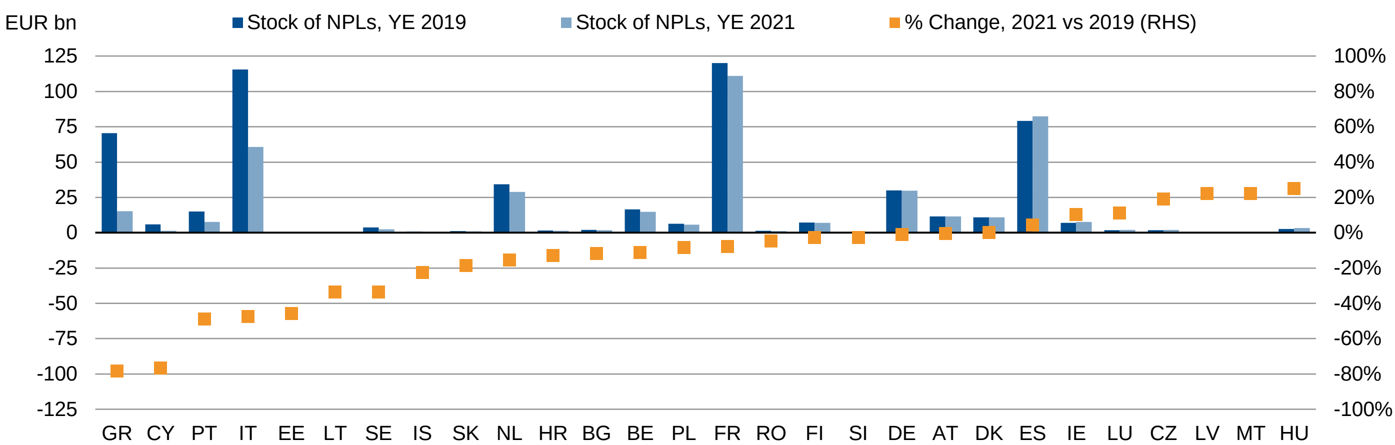
Figure 4: Overview of Stage 3 loans: 2019-2021



Customer loans at amortised cost. *YE 2021 vs YE 2020 for CaixaBank in 2020Y includes additions due to business combination with Bankia.
Source: SNL, banks, Scope Ratings

EBA country data confirm that the reduction of NPL stocks on banks' balance-sheets is broad based. Spain, Ireland and Hungary are the exceptions and have seen net NPLs increase. Large Irish banks are again addressing this issue, with renewed sales of NPLs. Another key feature is how concentrated the reduction in NPL stocks has been in a small number of countries, in particular in Greece (EUR 55.3bn), Italy (EUR 54.7bn) but also in Portugal, France and the Netherlands (Figure 5).

Figure 5: Distribution of NPLs among European countries (2020-2021)



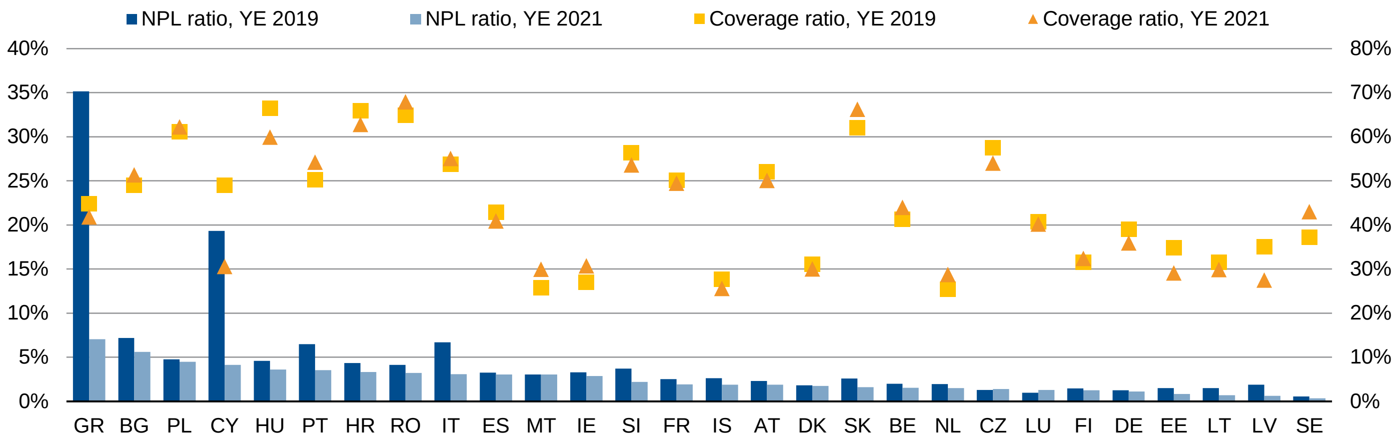
Source: EBA risk dashboard, Scope Ratings

NPL ratios converging but not coverage ratios

EBA data show that NPL ratios have converged across countries, which reflects the tighter regulatory steering of asset quality by European bank regulators in recent years, in particular since the Single Supervisory Mechanism was established.

We note, however, that there is greater dispersion in NPL coverage ratios, ranging from 25% to nearly 70% (Figure 6). This largely reflects the different structure of loan books in different countries, in particular with respect to the mix of mortgages vs corporate loans vs SME loans, the availability of collateral (typically real estate) and ultimately differing expected losses upon default. Within comparable segments, we expect the combination of IFRS 9 accounting and supervisory expectations to lead to a gradual convergence in this metric as well.

Figure 6: NPL ratios and coverage ratios across European countries



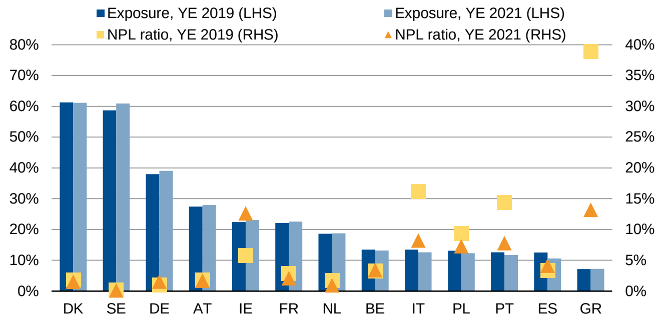
Country ranking by decreasing order of NPL ratios at end 2021. Source: EBA risk dashboard, Scope Ratings

No reversal yet at sector level

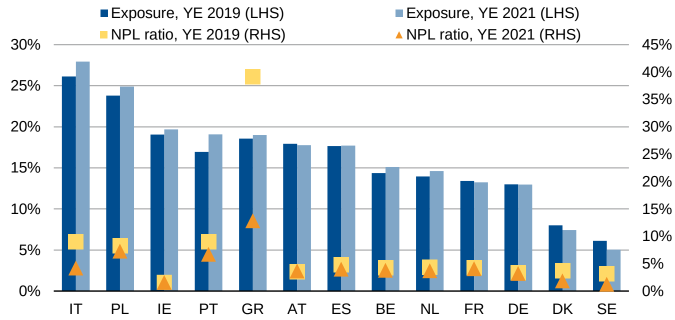
EBA data provide a proxy for asset quality for a set of sensitive or large economic sectors in a variety of countries. Until the end of 2021, asset quality had followed a positive trend, even for the sectors identified as the most vulnerable during the pandemic. There are only a very few cases were NPL ratios at end-2021 (triangle) have deteriorated in comparison to end-2019 (square) such as the accommodation and food sector in Spain or Ireland (Box A, Figure F) but the size of these exposures is modest and the recovery has helped since end-2021.

Box A: Developments in asset quality and exposures to vulnerable sectors

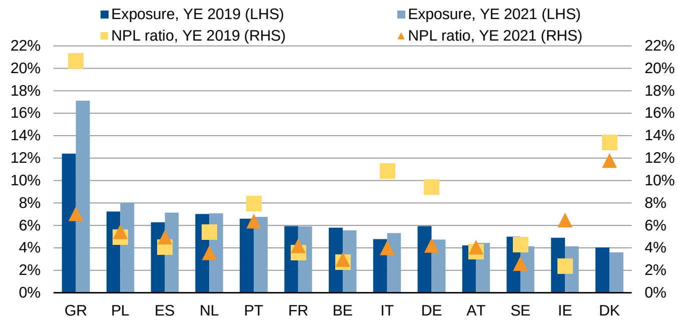
A: Real estate



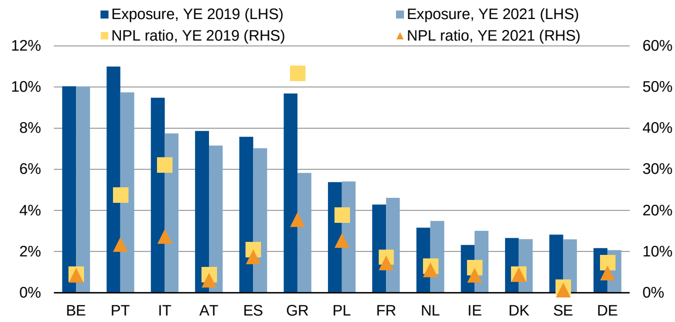
B: Manufacturing



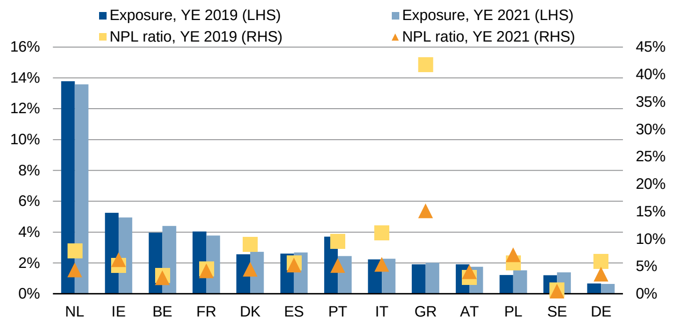
C: Transport and storage



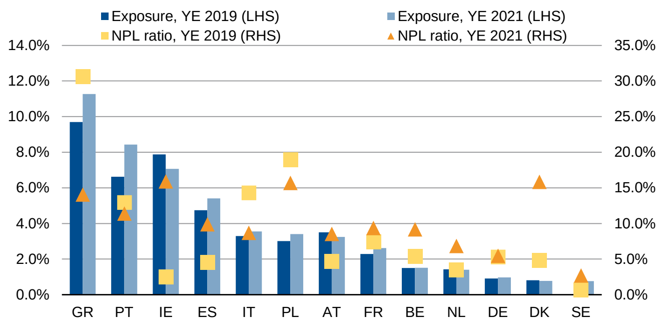
D: Construction



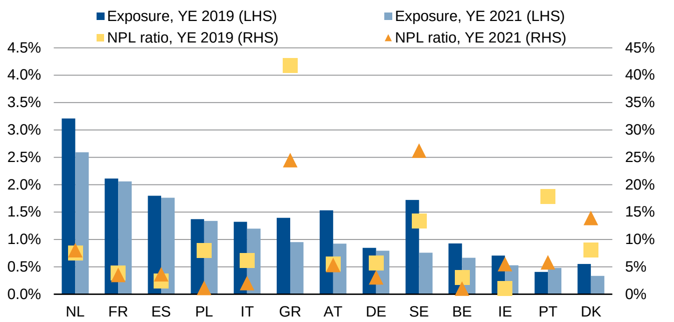
E: Agriculture



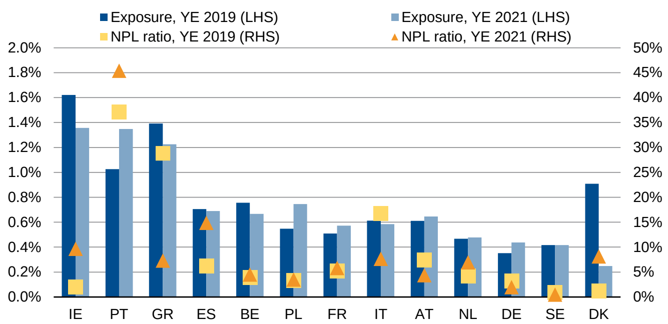
F: Accommodation and food services sector



G: Mining and quarrying (includes oil sector)



H: Arts, entertainment and recreation sector



Charts are organised by average size of sector exposure of EU/EEA banks. Source: EBA, Scope Ratings

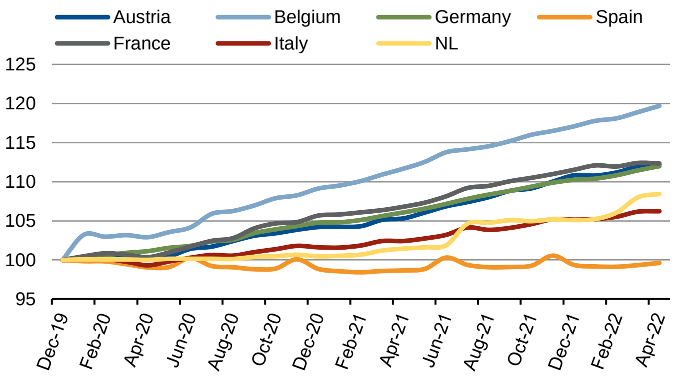
Higher NII means higher loss absorption capacity for banks

Rising interest rates should have a positive impact on bank's revenue generation, hence their loss absorption. Banks' balance-sheets are positioned to benefit from this. Margins should widen and net interest income increase.

Because balance-sheet repricing will take some time, the benefit of rising interest rates will be gradual, especially for banks that have increased their share of lending at fixed rates, in particular mortgage lending, which represents a significant portion of many European banks' loan portfolios.

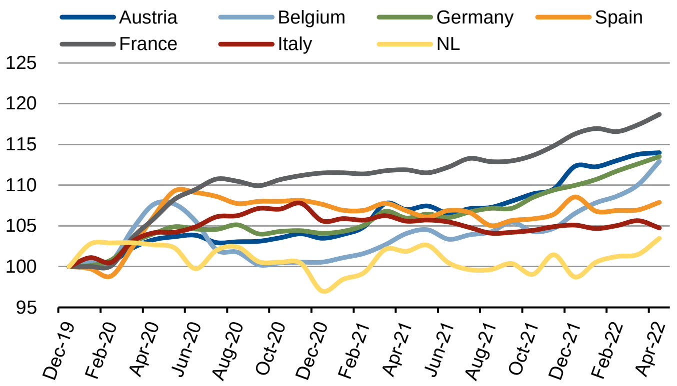
Tightening financial conditions will also limit credit demand. Lending dynamics remained solid during the pandemic, helping banks to compensate for low rates. Even recent geopolitical developments and the less supportive economic outlook have had little impact on credit demand and supply (Figures 7 and 8). This is likely to change. The ECB expects that the tightening of financial conditions will help easing overheating in the residential real estate sector in some countries. This effect may be delayed if credit demand remains high in anticipation of a continuing increase in interest rates.

Figure 7: Outstanding loans to households (100 = Dec. 2019)



Outstanding domestic loans granted by monetary financial institutions.
Source: ECB, Scope Ratings

Figure 8: Outstanding loans to corporates (100 = Dec. 2019)



Outstanding domestic loans granted by monetary financial institutions.
Source: ECB, Scope Ratings

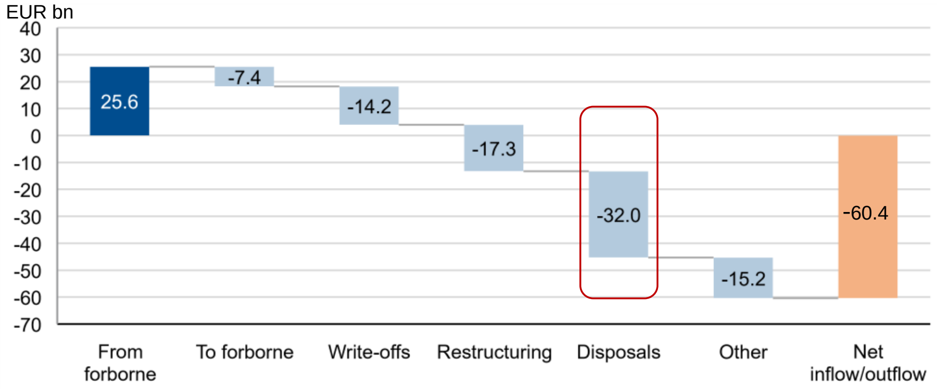
Active NPL management: a potential game changer for European banks

Three interrelated factors explain the massive reduction of NPL across Europe since 2015: improving macroeconomic conditions, banks' management of their credit portfolios and a series of regulatory initiatives to incentivise banks to offload bad loans.

Irrespective of expectations about new defaults, the on-balance sheet stock of NPLs will also depend on the functioning of a more sophisticated mechanism to manage NPLs. Considering the initially slow reduction of the stock of NPLs inherited from the global financial crisis, efforts to solve the bottlenecks that existed plus some innovations have accelerated the speed at which banks can off load NPLs. This is a work in progress.

NPL transfers account for the lion's share of the reduction in NPLs since the onset of the pandemic (Figure 9).

Figure 9: Importance of sales and securitisations in the reduction of European banks' NPLs



From ECB financial stability review (May 2022), chart 3.1.b. Data covers the period from Q2 2020 to Q4 2021.
Source: ECB, Scope Ratings

The recourse to risk transfer mechanisms is positive for banks' creditworthiness because it allows for better control of asset-quality metrics. In Italy, the GACS scheme has allowed banks to offload around EUR 100bn of bad debt since its launch in 2016. If it continues to work under more difficult economic conditions, the net impact of asset quality deterioration on banks' balance sheets could be modest. The stock of NPL on banks' balance sheets may never return to post-GFC levels or reach the EUR 1trn mark.

Offloading NPLs is a more efficient way for banks to manage legacy bad debt. This is not to say that NPLs disappear – and there are implications for the rest of the financial system – but by selling portfolios the banking sector is ultimately in better shape. It assumes, however, that banks do not re-enter by the back door, buying securitised products, or at least the riskier tranches.

Selected initiatives contributing to active NPL management (implemented or under discussion)

- Introduction in 2018 of IFRS 9 to facilitate the recognition of non-performing loans
- Requirement for individual banks to define and submit an NPL strategy.
- Paving the way for the creation of a more efficient secondary market for distressed assets. It includes the introduction of NPL transaction templates to increase data standardisation and transparency. The publication in December 2021 of the Directive on credit servicers and credit purchasers ('the NPL Directive') was a milestone.
- Introduction of capital incentives to manage NPLs in more dynamic manner. These include a 'prudential backstop' requiring banks to meet minimum provision coverage requirements. In case a bank does not meet the applicable minimum coverage level, it has to deduct the shortfall from its own funds.
- Increasing convergence of corporate insolvency and debt recovery legislations
- Establishment of additional national asset management companies (AMC) and eventually an EU network of AMCs (as an alternative of an EU AMC).

Appendix: Country/region sections

How to read the charts in the following pages

Charts A and E highlight trends in cost of risk against long-term trends.

Chart A: cost of risk as a percentage of pre-impairment income over 2007-2021, highlighting the impact of the Covid-19 crisis in 2020/2021 versus 2019

Chart E: Credit cost (calculated as credit impairment charges as a percentage of average gross customer loans)

Charts B and C compare customer loans by Stage (1, 2, 3)

Chart B: composition of loan portfolios (customer loans at amortised cost)

Chart C: stage bucket year-on-year movements

Chart D compares non-performing loan (Stage 3) coverage levels

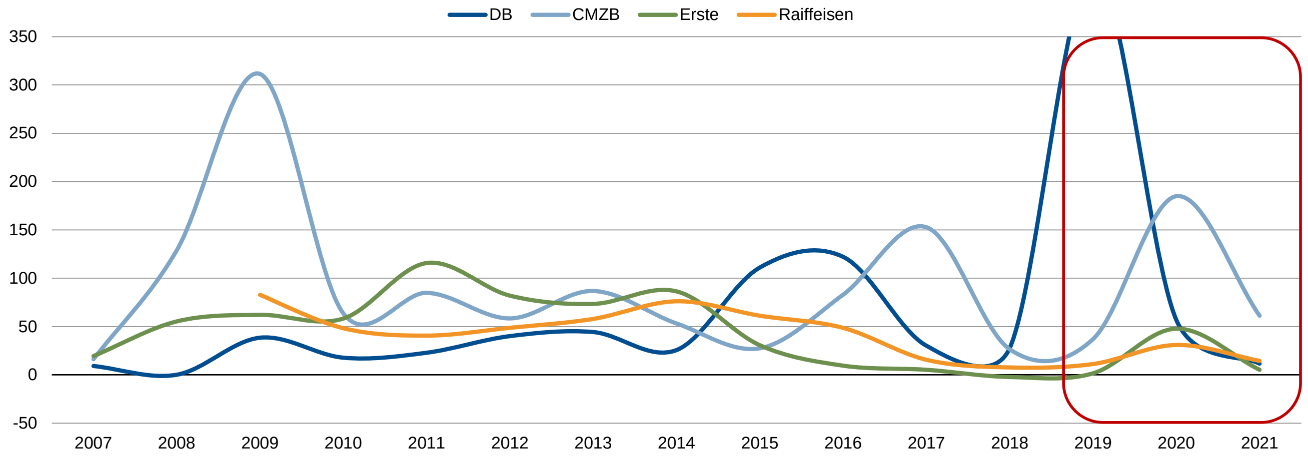
Coverage relative to Stage 3 provisions (loan specific)

Asset Quality Review: do rising interest rates mean rising NPLs for European banks?

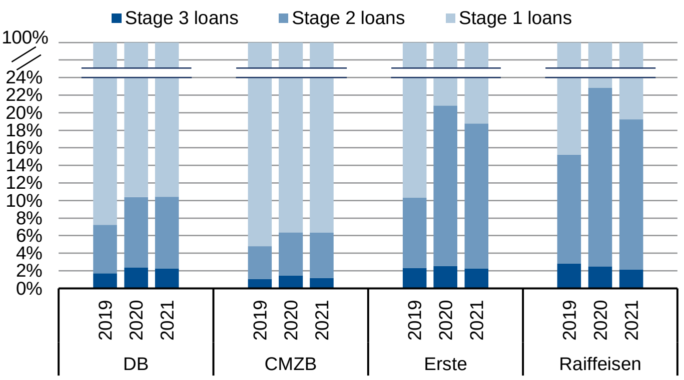
Austrian and German banks

Long-term trends	Recent developments & emerging trends
• Corporate sectors generally very liquid, but increasing energy costs and supply chain bottlenecks represent downside risks for credit quality • Diversified and granular loan books, especially well positioned in the real estate sector • Although pandemic-related portfolio reserves provide some buffer against deteriorating credit quality, CoR will increase moderately	• Following slight normalisation in 2021 Stage 2 loans are likely to increase. Stage 3 loans will also increase to above pre-crisis levels. • Overall, impact from loan quality deterioration will remain manageable. MODERATE pressure for Austrian banks (also due to CEE exposure). MODERATE pressure for German banks with respect to above average exposures to energy consuming manufacturing industries

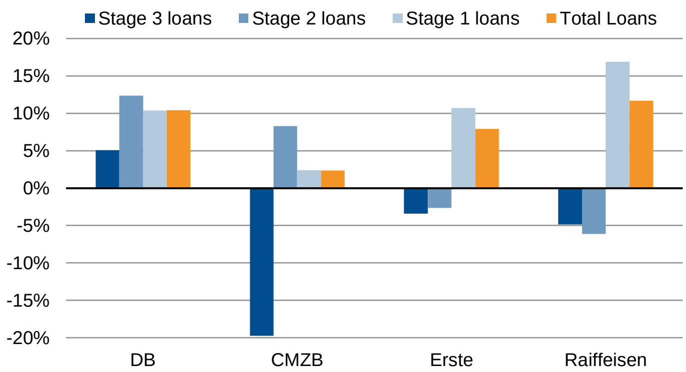
A. Credit impairment charges as % of pre-impairment income



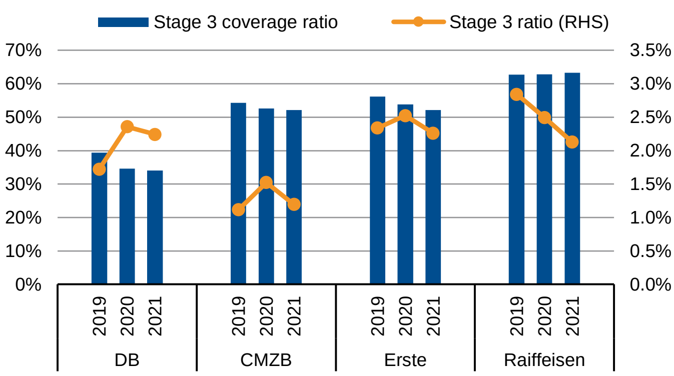
B. Breakdown of customer loans by stage



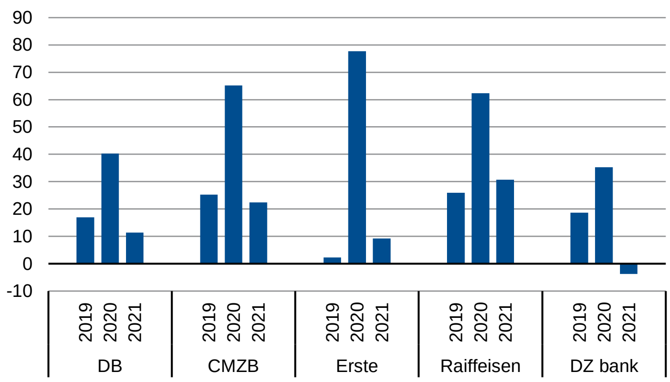
C. Customer loans by stage (% change, YE2021 vs YE2020)



D. Coverage of Stage 3 loans and Stage 3 ratio



E. Credit cost (bp)

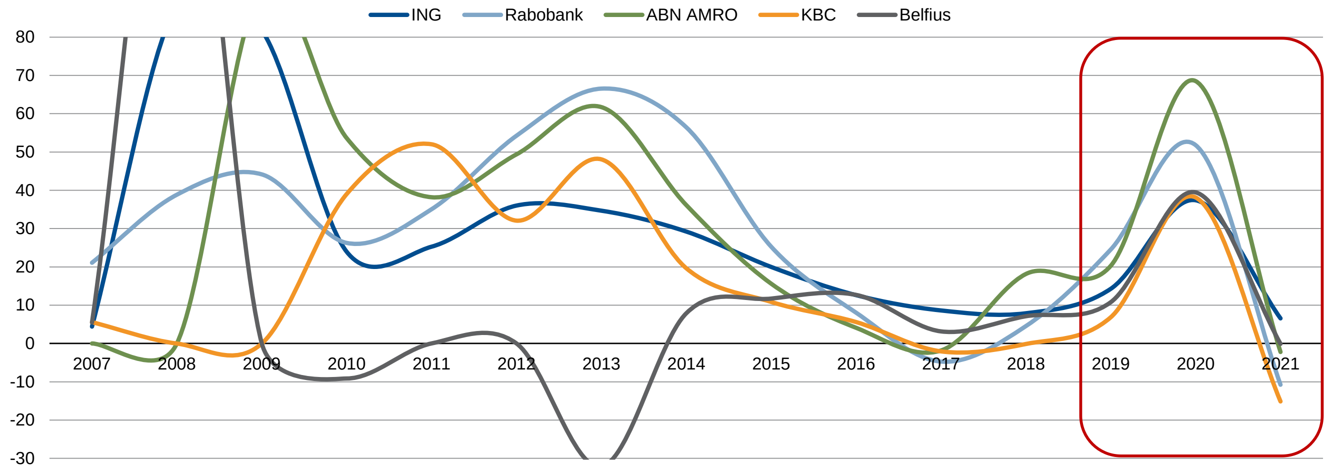


DB: Deutsche Bank; CMZB: Commerzbank; Erste: Erste Group; Raiffeisen: Raiffeisen Group.

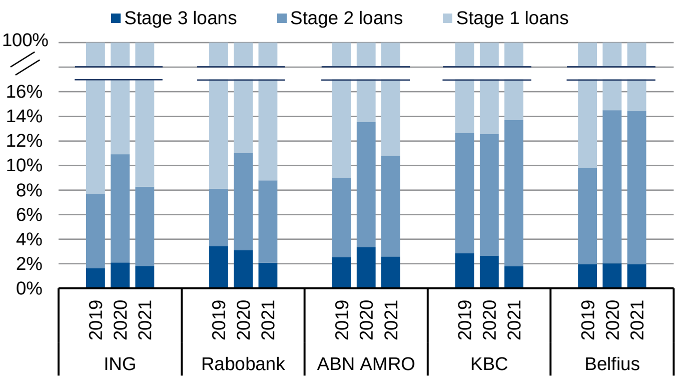
Belgian and Dutch banks

Long-term trends	Recent developments & emerging trends
• Domestic mortgage portfolios due to reduce in the Netherlands with the gradual shift from interest-only mortgages to amortising loans. Low interest rates on deposits also incentivise customers to accelerate mortgage repayments. • Dutch banks' tendency to lend against collateral explains why provisioning levels are lower than those of peers.	• Provision reversal in 2021 reflected improving economic prospects

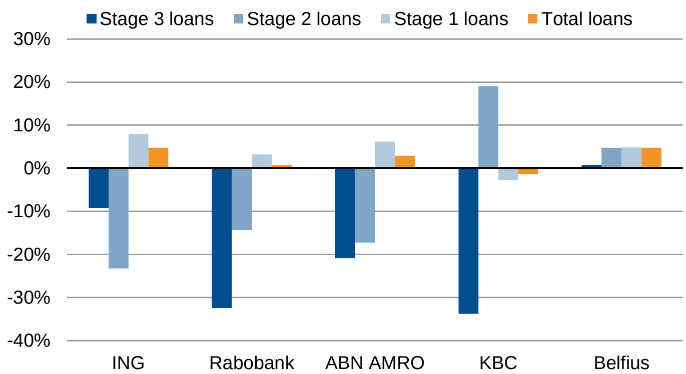
A. Credit impairment as % of pre-impairment income



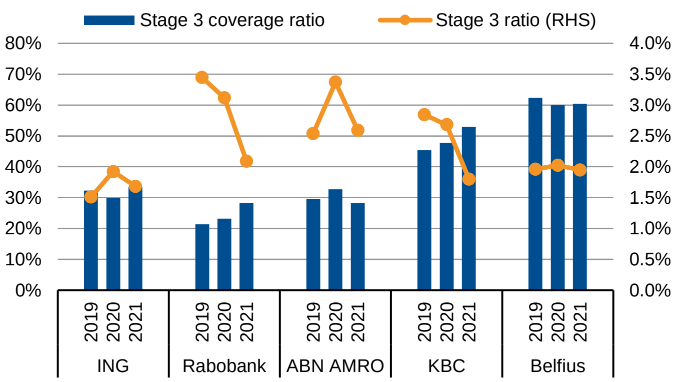
B. Breakdown of customer loans by stage



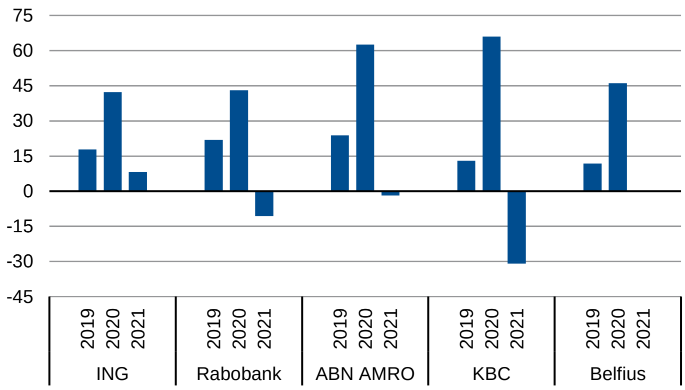
C. Customer loans by stage (% change, YE2021 vs YE2020)



D. Coverage of Stage 3 loans and Stage 3 ratio



E. Credit cost (bp)

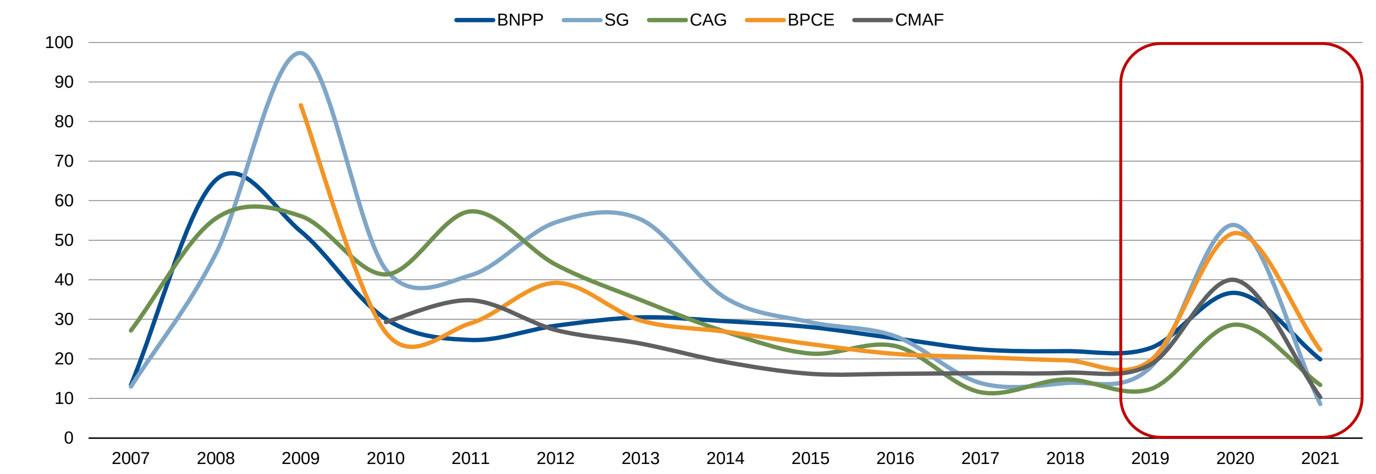


ING: ING Group; Rabobank: Cooperatieve Rabobank; ABN AMRO: ABN AMRO Bank; KBC: KBC Group. ING Group: estimated Stage 1 loans.
Source: SNL, banks, Scope Ratings.

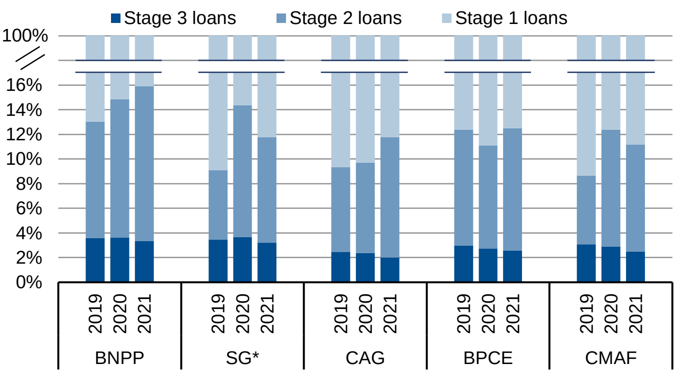
French banks

Long-term trends	Recent developments & emerging trends
• Diversified and granular loan books • Conservative provisioning policies • NPL ratios in line with EU average	• Uninterrupted growth of customer loans • Massive State-guaranteed loan programme

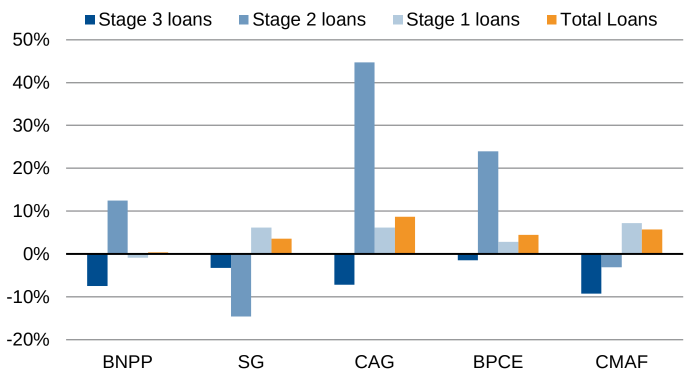
A. Credit impairment as % of pre-impairment income



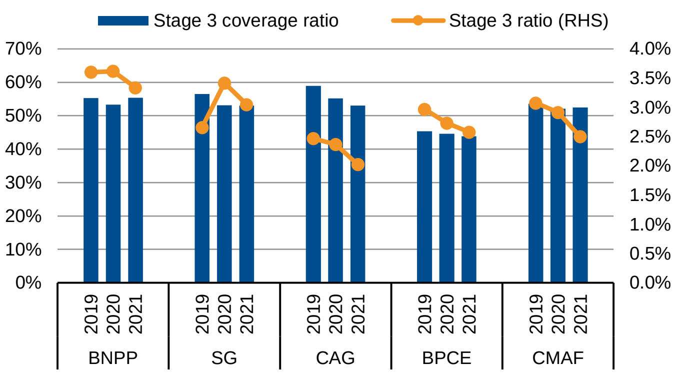
B. Breakdown of customer loans by stage



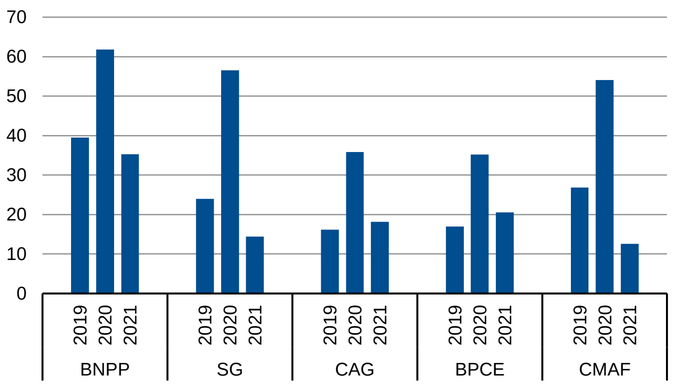
C. Customer loans by stage (% change YE2021 vs YE2020)



D. Coverage of Stage 3 loans and Stage 3 ratio



E. Credit cost (bp)

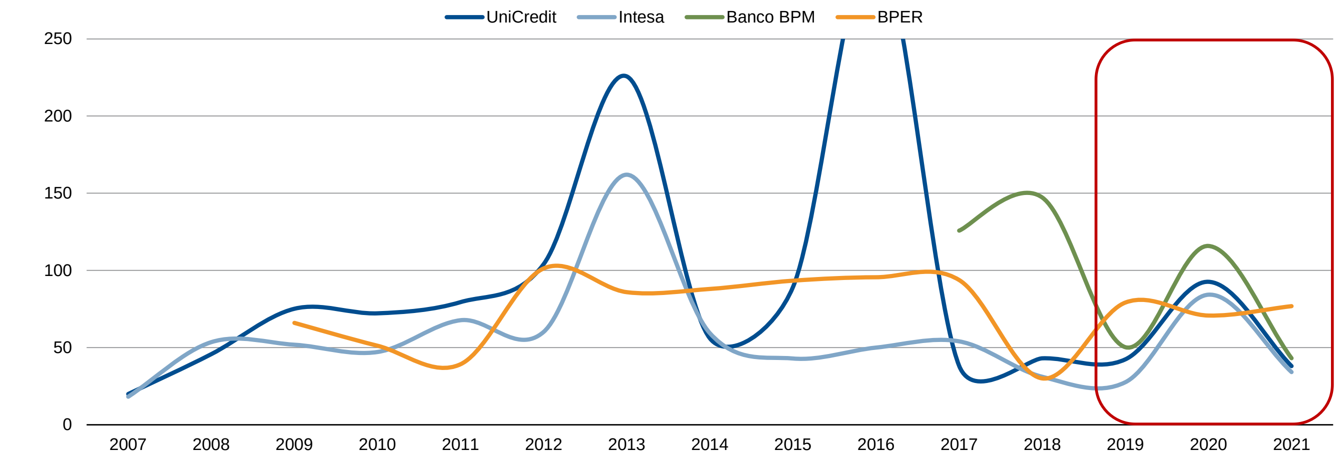


Notes: BNPP: BNP Paribas; SG: Société Générale; CAG: Crédit Agricole Group; BPCE: BPCE Group; CMAF: Crédit Mutuel Alliance Fédérale (part of Crédit Mutuel Group). Figure B: *SG: estimated evolution of Stage 2 loans.
Source: SNL, banks, Scope Ratings.

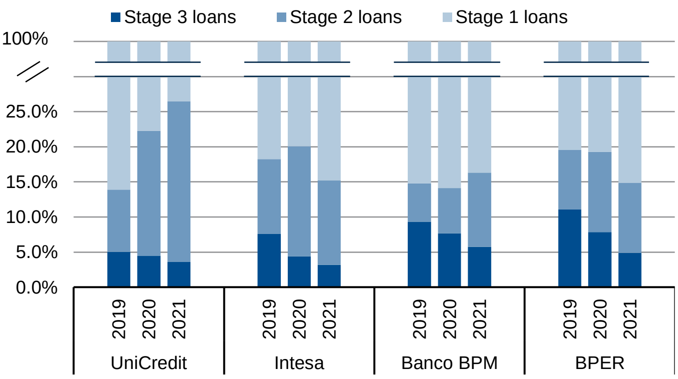
Italian banks

Long-term trends	Recent developments and emerging trends
• High exposure to SME lending, traditionally riskier than secured retail loans and large corporate financing • Secular improvement in credit origination • Lengthy NPL resolution processes • GACS proved effective to facilitate NPL sales. Italy is working to replace it with a new scheme.	• De-risking of legacy NPLs almost complete • New NPLs shielded by Covid support measures so far. However, Stage 2 ratios have increased. • War in Ukraine: lending to companies exporting to Russia/Ukraine minimal; however energy-intensive corporates represent 8% of total performing loans.

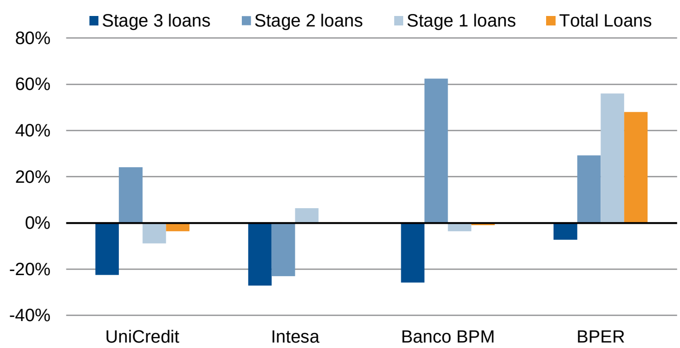
A. Credit impairment as % of pre-impairment income



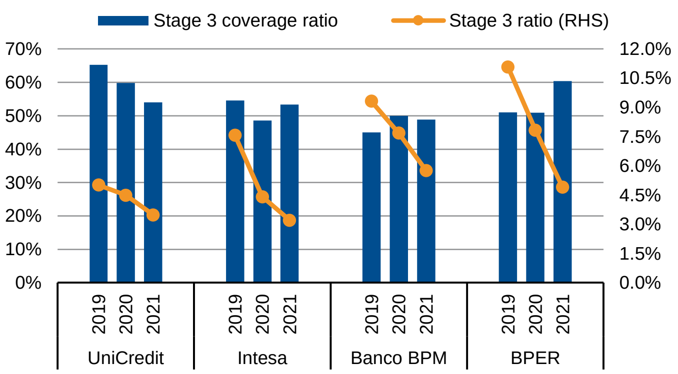
B. Breakdown of customer loans



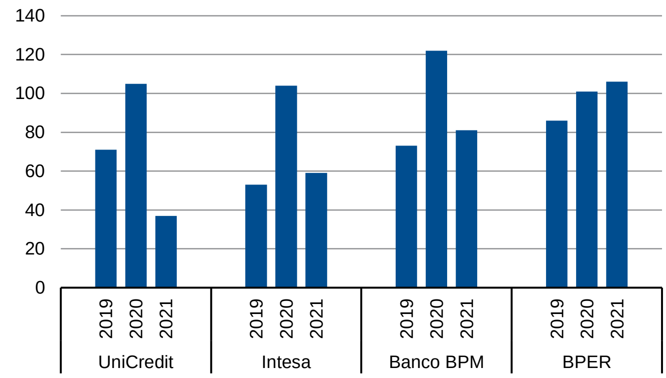
C. Customer loans by stage (% change YE2021 vs YE2020)



D. Coverage of Stage 3 loans and Stage 3 ratio



E. Credit cost (bp)



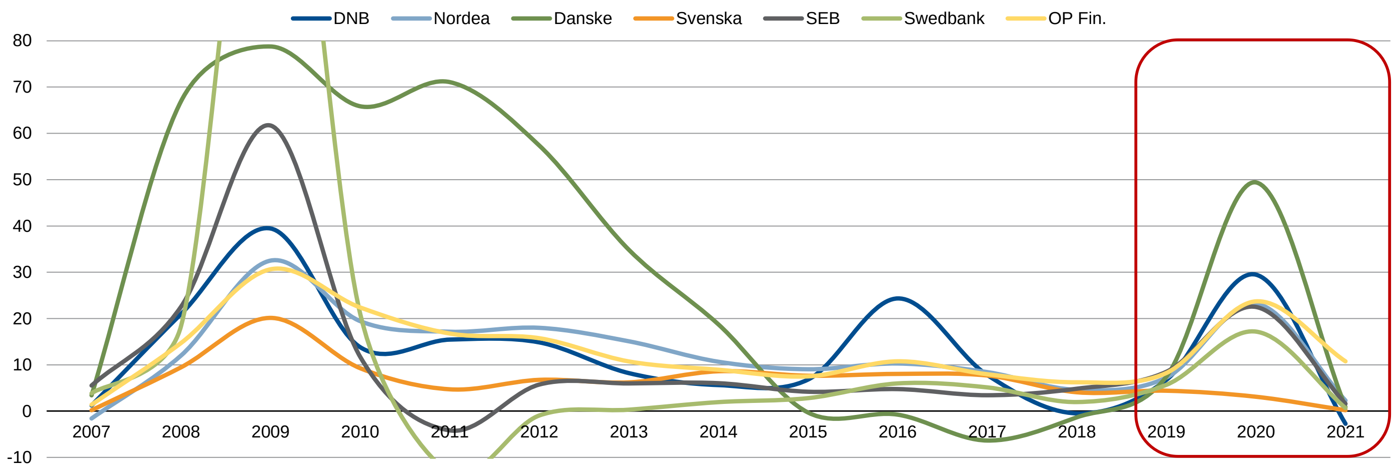
Notes: Intesa: Intesa Sanpaolo (in figure E, 2019 and 2020 data were not restated to account for UBI acquisition carried out in 2020); BPER: BPER Banca (in figure C, 2020 data were not restated for the change in perimeter in 2021). Figure A: data for Banco BPM starts from the bank's inception (2017).
Source: SNL, banks, Scope Ratings.

Asset Quality Review: do rising interest rates mean rising NPLs for European banks?

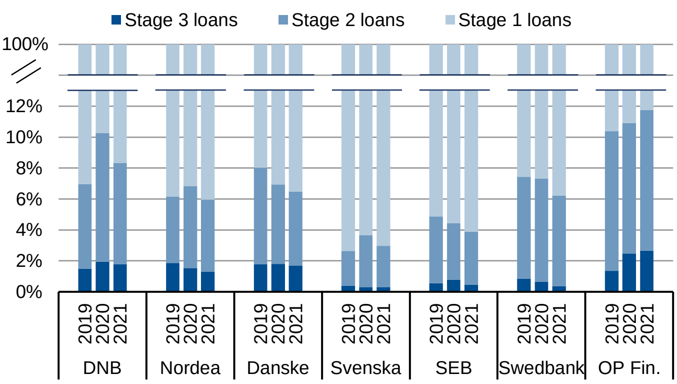
Nordic banks

Long-term trends	Recent developments & emerging trends
• Very supportive macroeconomic environment supports asset quality • Swedish banks continue to display some of the lowest NPL ratios • Exposure to oil and gas industry is a driver of credit impairments	• Strong economic recovery from pandemic with central banks raising rates and countercyclical capital buffers • Higher energy prices provide support for oil and gas exposures

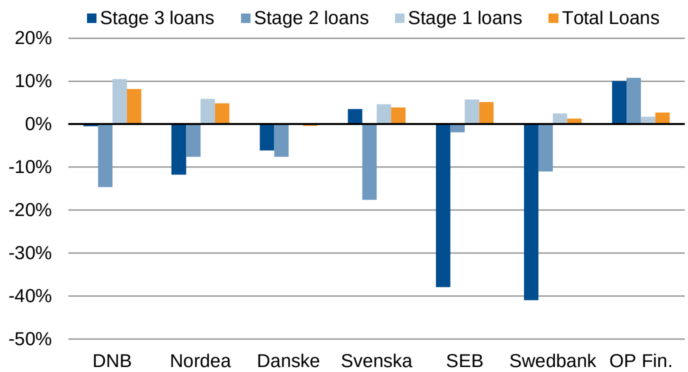
A. Credit impairment as % of pre-impairment income



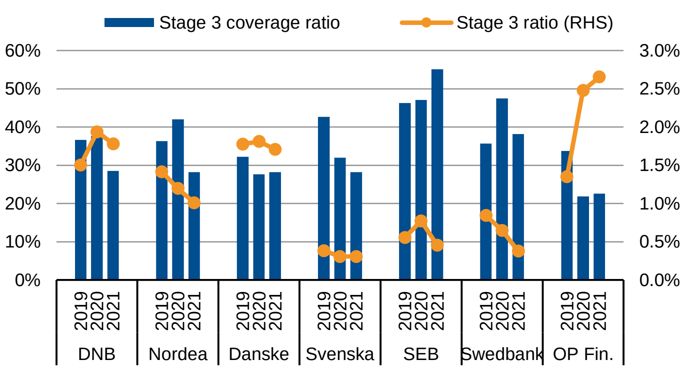
B. Breakdown of customer loans by stage



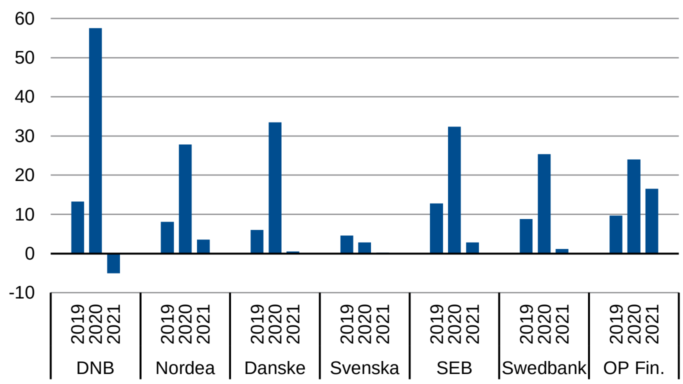
C. Customer loans by stage (% change, YE2021 vs YE2020)



D. Coverage of Stage 3 loans and Stage 3 ratio



E. Credit cost (bp)

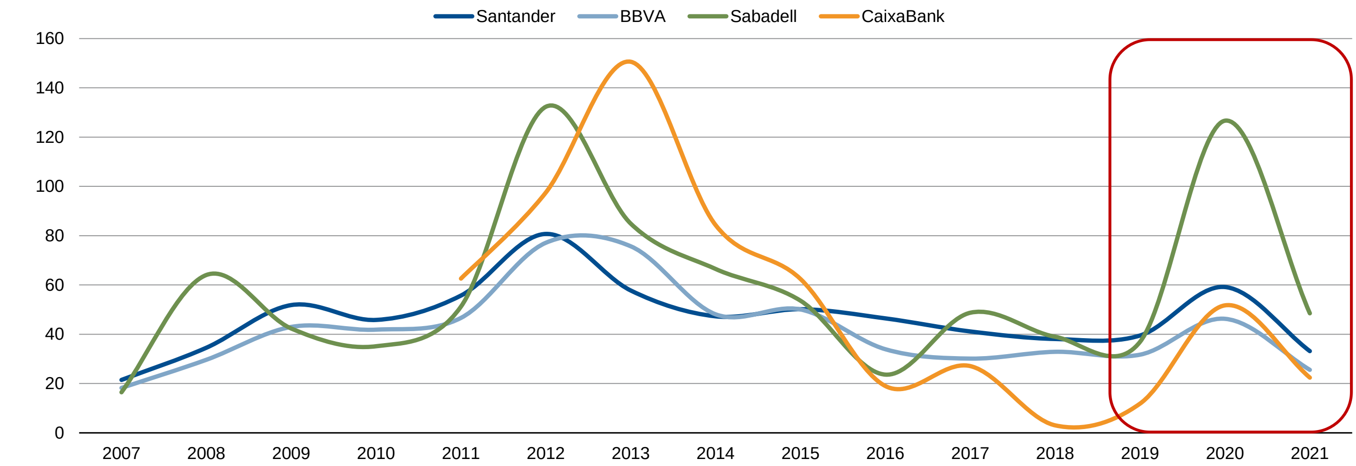


Note: DNB: DNB Bank; Nordea: Nordea Bank; Danske: Danske Bank; Svenska: Svenska Handelsbanken; SEB: Skandinaviska Enskilda Banken; OP Fin.: OP Financial Group. Source: SNL, banks, Scope Ratings

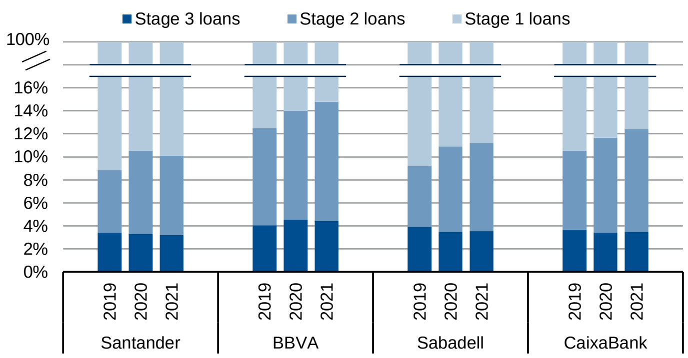
Spanish banks

Long-term trends	Recent developments & emerging trends
• Average NPL ratio has converged to core EU peer countries' • De-risking of non-performing loans slower than in Italy and Portugal but starting from better standpoint. • Lower share of legacy NPLs at the onset of the crisis, however foreclosed real estate assets still material.	• Continuing de-risking, high coverage on NPLs. • CoR in 2021 trending down but still above pre-pandemic levels, given prudent approach to potential inflows from Stage 2. • Credit quality of ICO-backed loans is deteriorating in aggregate. National measures adopted for the war in Ukraine should help servicing ability of more vulnerable borrowers (and delay recognition).

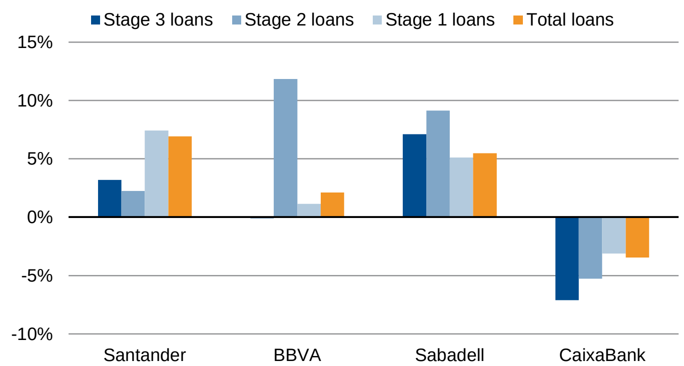
A. Credit impairment as % of pre-impairment income



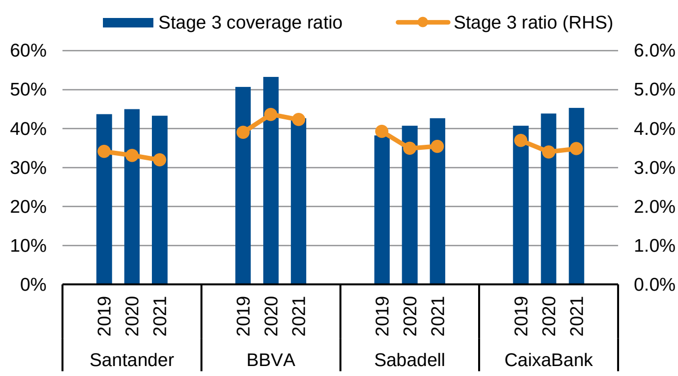
B. Breakdown of customer loans by stage



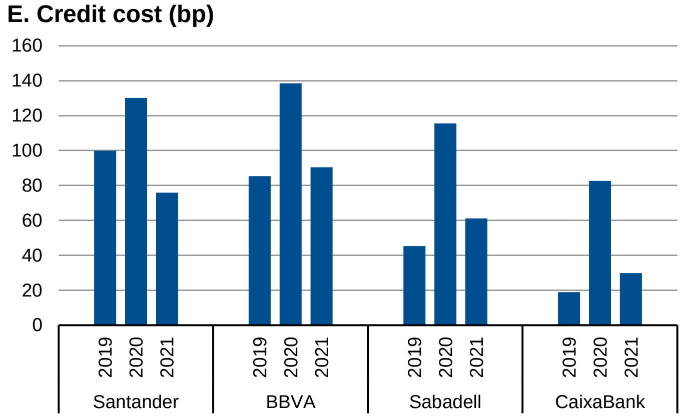
C. Customer loans by stage (% change, YE2021 vs YE2020)



D. Coverage of Stage 3 loans and Stage 3 ratio



E. Credit cost (bp)

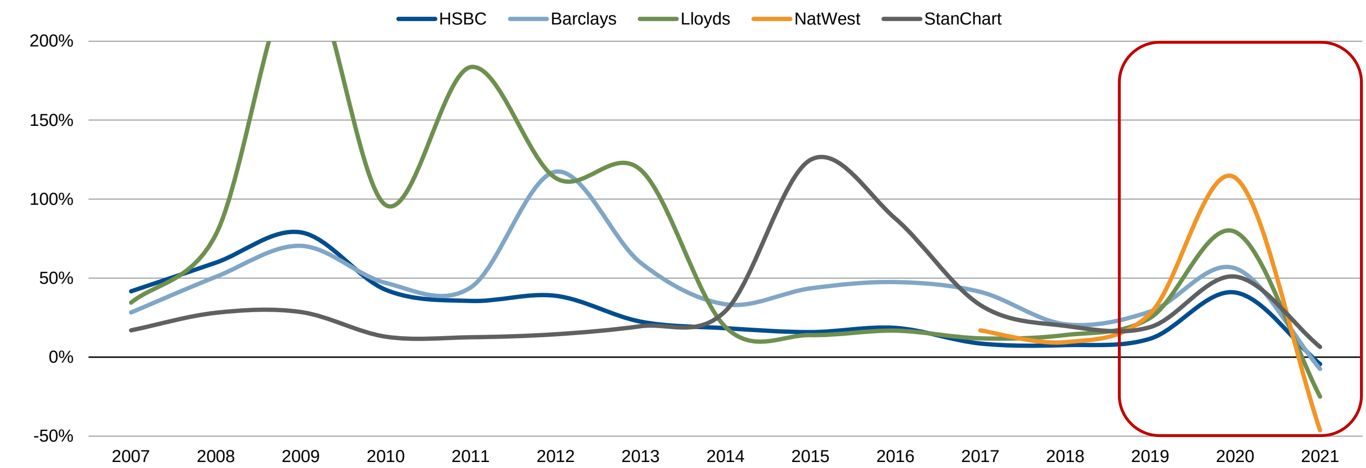


Notes: Santander: Banco Santander; BBVA: Banco Bilbao Vizcaya Argentaria (movements highlighted in chart C mainly reflect sale of US activities); Sabadell: Banco de Sabadell; CaixaBank: figures A, B, D, E standalone in 2019 and 2020, figure C 2020 restated to include additions due to business combination with Bankia.
Source: SNL, banks, Scope Ratings.

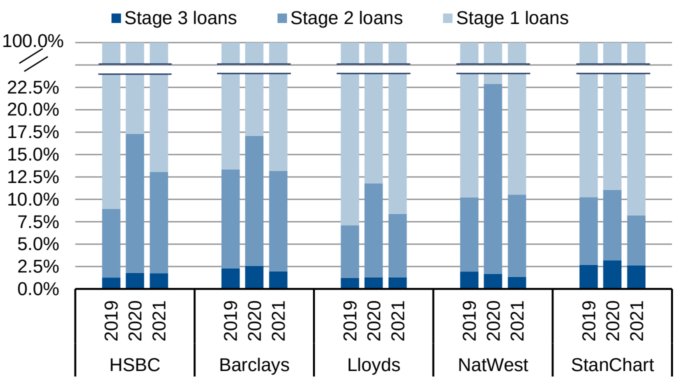
UK banks

Long-term trends	Recent developments & emerging trends
• Low loss rates on UK and HK retail mortgages continue to support asset quality • Reduced risk appetite in recent years driven by restructuring and Brexit uncertainties	• Pandemic provisions being released. New provisions for inflation and cost of living concerns as well as Chinese commercial real estate. • Banks maintain cost of risk guidance • Unsecured consumer loan exposures slowly recovering • SMEs continue to repay loans

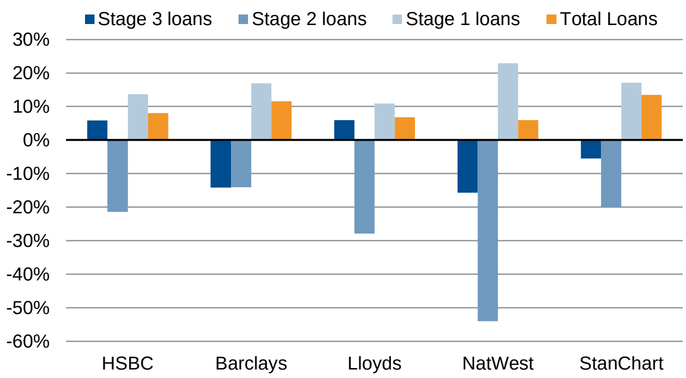
A. Credit impairment % Pre-impairment operating profit



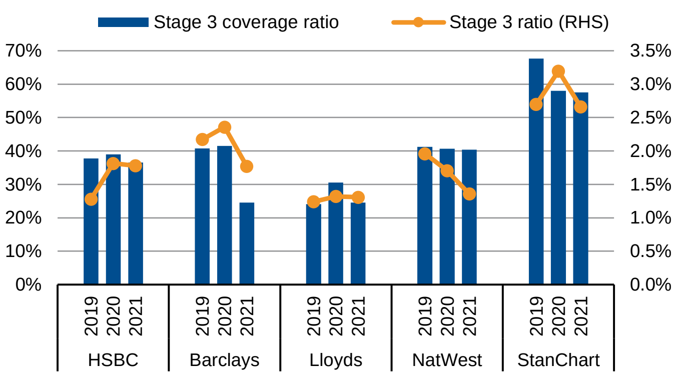
B. Breakdown of customer loans by stage



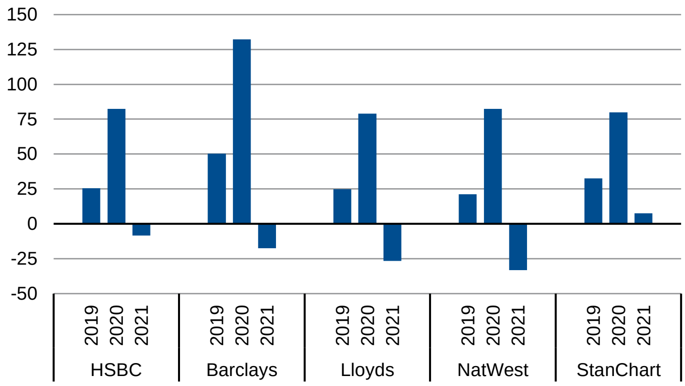
C. Customer loans by stage (% change, YE2021 vs YE2020)



D. Coverage of Stage 3 loans and Stage 3 ratio



E. Credit costs (bp)



Note: HSBC: HSBC Holdings; Lloyds: Lloyds Banking Group; NatWest: NatWest Group; StanChart: Standard Chartered.
Figure A: For NatWest, data prior to 2017 is not shown as there were several years of pre-impairment operating losses.
Source: SNL, banks, Scope Ratings.

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