Asset-quality Quarterly: European NPL ratios at a standstill but will bottom out in 2021

Despite the significant decline in economic activity since the outbreak of the pandemic, European banks are not at this point facing an asset-quality shock. Non-performing loan ratios have actually improved, reflecting a lag in NPL recognition that was further extended by government support measures for borrowers. We expect NPL ratios to bottom out in 2021. But assuming vaccination plans are not derailed, proactive precautionary provisioning efforts last year will likely keep the need for new provisions within manageable bounds.

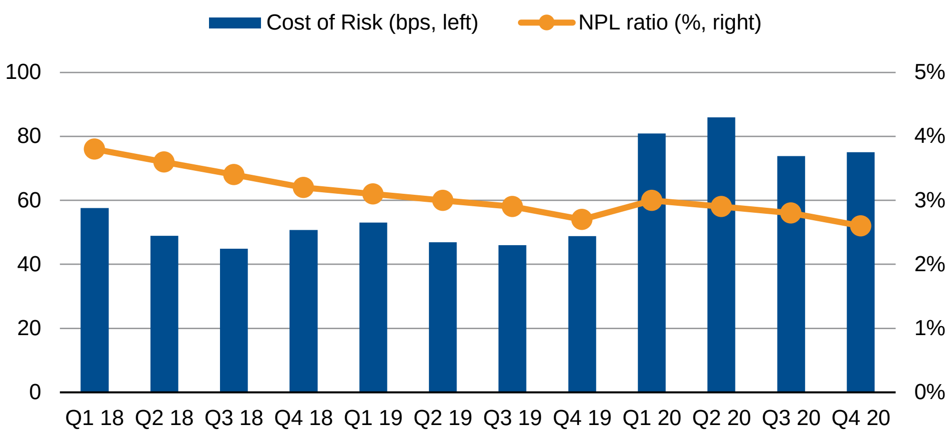
Banks' cost of risk peaked in the middle of 2020 at a moderate aggregate level (Figure 1). Banks generally anticipate a decline in the cost of risk in 2021, converging towards the average through-the-cycle level. Several factors explain the resilience of asset-quality indicators:

- Considerable public support preventing a general economic collapse as well as a credit crunch. This means that loan books, as the denominator of NPL ratios, continued to expand despite the slow-down.
- Proactive management of the stock of existing problem loans in anticipation of a deterioration in asset quality.
- Accommodating regulatory forbearance measures, especially moratoriums, delaying the recognition of new problem loans.

Recovery paths will diverge across Europe. Asset-quality metrics are more at risk of deterioration in open economies sensitive to international trade volatility, those relying on tourism, displaying lacklustre domestic demand or delayed vaccination programmes that will prevent the swift re-opening of economies in 2021.

Two trends deserve special attention. First, pressure points in selective corporate lending portfolios are becoming more visible but manageable. Credit exposure to the sectors most affected by public-health measures are either small and granular (hospitality, entertainment) or benefit from government support (airlines). Second, strategies to wind down broad support measures, and how this will impact borrowers and guarantors, are unknown.

Figure 1: EU weighted average cost of risk (basis points, left) and NPL ratio (%, right)



EU weighted averages. Source: EBA risk dashboard, Scope Ratings.

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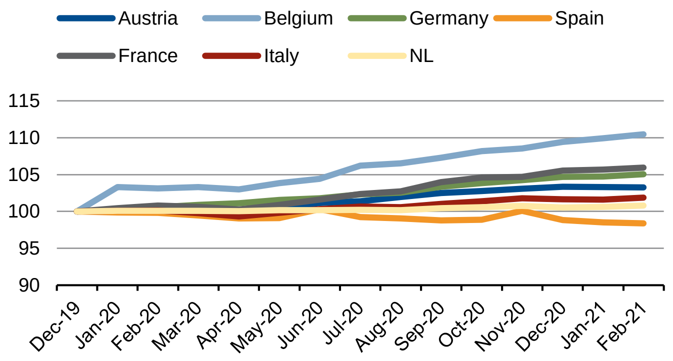
‘Banks are part of the solution’: uninterrupted credit supply is the first factor explaining the resilience of NPL ratios

Lending dynamics so far preserved

Banks continued to lend throughout 2020 to households and to corporates (Figures 2 and 3). The absence of a credit crunch, despite declining economic activity and an uncertain outlook, has been an important element in avoiding a general economic collapse. Lending portfolios have generally continued to expand, contributing to preserving companies’ liquidity positions. Expanding credit to households, meanwhile, mainly reflects the resilience of residential property markets.

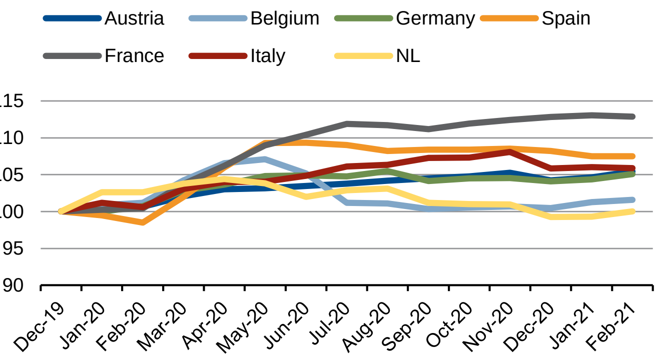
The continuing expansion of bank lending in a more challenging operating environment has been a source of concern for regulators. France’s High Council for Financial Stability (Haut Conseil de stabilité financière), the country’s macroprudential authority, issued warnings about this, for instance. In the meantime, inflated bank deposits have mitigated this risk given the tendency of bank customers to park excess precautionary liquidity in bank accounts. The net position of borrowers appears to be less of an issue in aggregate.

Figure 2: outstanding loans to households (100 = Dec. 2019)



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

Figure 3: outstanding loans to corporates (100 = Dec. 2019)



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

Government-backed lending programmes provided a short-term temporary liquidity boost

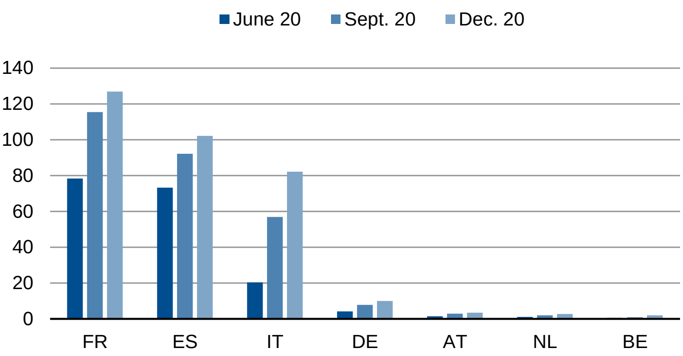
Significant recourse to large-scale lending programmes

State-guaranteed loan programmes put in place at the time of the first lockdowns were intended to boost corporate liquidity positions. Among the large EU countries, recourse to large-scale lending programmes was significant in France, Spain and Italy (Figure 4). Support measures kept increasing until the end of 2020 but they will stabilise as eligibility criteria limit the possibility of expanding the scope of beneficiaries or the amount borrowed. Of note, the EBA census of government-backed lending programmes in Figure 4 only shows recently established loan schemes whereas already existing State-backed lending programmes were also reactivated but do not show up in these computations, e.g. in the Netherlands or Germany.

The substitution of bank lending by government-backed schemes occurred despite the requirement set on banks in some countries (e.g. France and Italy) to contribute to a net increase in borrowers’ lending positions at origination. While the risk transfer is credit-positive for banks, so far it appears that the credit quality of these loans is in line with average NPL ratios (Figure 5).

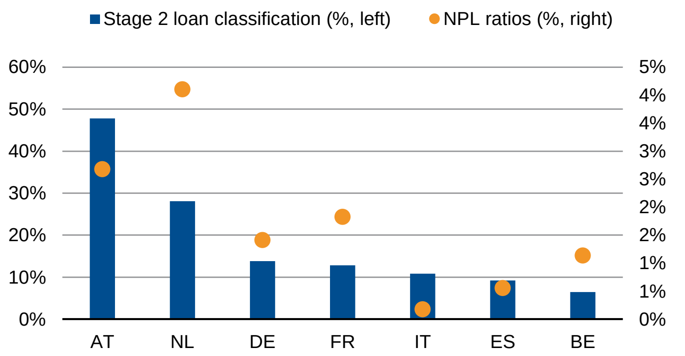
Paying back loans intended to boost liquidity is due to take place over extended periods, with significant grace periods. This approach will delay the identification of problem loans or the most fragile borrowers. In countries where the truly exceptional support measures of these ad hoc programmes were offered to a very small portion of borrowers, banks have tended to classify the exposures as stage 2 loans (e.g. Netherlands and Austria; Figure 5).

Figure 4: EBA census of newly originated loans subject to public guarantee schemes (EUR bn)



Source: EBA, Scope Ratings.

Figure 5: asset quality of loans subject to public guarantee schemes (%)



Source: EBA, Scope Ratings.

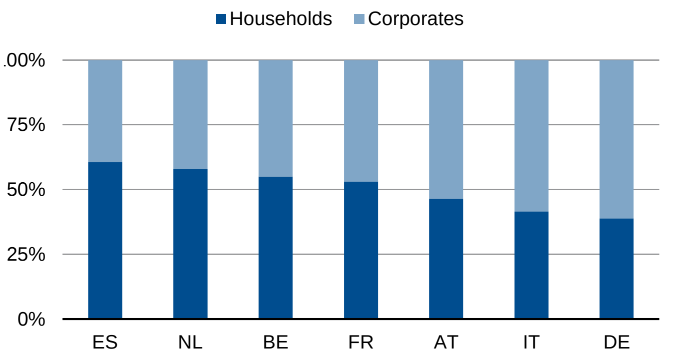
Diversified sector lending has been a key credit risk mitigating factor

Balance of loan books contributed to risk mitigation

The balance of loans books between households and corporates also helped mitigate credit risk for banks (Figure 6). Retail lending portfolios display traditionally lower NPL ratios. These portfolios are largely secured, often by prime residential property or are adequately priced to absorb the increasing cost of risk e.g. in consumer finance. Resilient property markets due to low rates and generous measures to support employment and furlough helped maintain the quality of these portfolios.

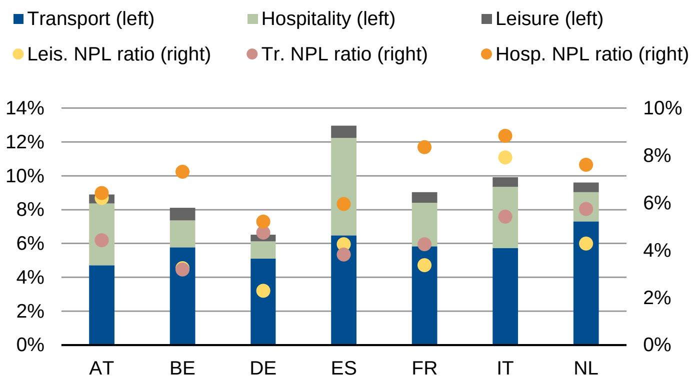
Another mitigant has been the relatively small credit exposure to corporate sectors most sensitive to public-health measures, from transportation to hospitality or the leisure industry, where NPL ratios already stand much higher than average portfolio levels (Figure 7).

Figure 6: balance of outstanding loans between households and corporates



Source: EBA, Scope Ratings

Figure 7: outstanding loans to corporates (100 = end 2019)

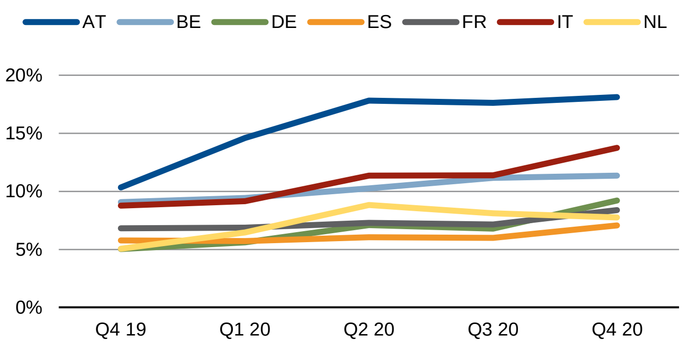


Source: EBA, Scope Ratings

Use of IFRS 9 loan classification to earmark potential problem loans varies

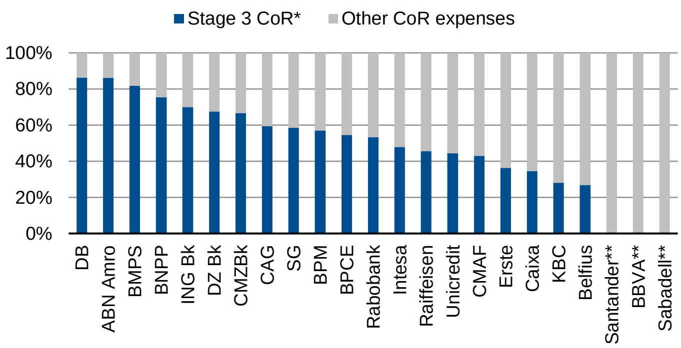
The use of stage 2 loan classification has varied across EU countries (Figure 8). This ‘watch list’ approach can be used for individual files or entire sector exposures. The increase in stage 2 loans ratio was noticeable over 2020, reaching 9.1% from 6.8% at end 2019. The share of stage 2 loans has significantly increased for loans under non-expired moratoriums (26.4% at EU level at end-2020, compared to 16.7% at end-June 2020). Because of its judgmental component, it remains to be seen to what extent the classification of stage 2 loans and the corresponding increase of stage 2 provisions will prove volatile quarter-to-quarter, leading to reversals, or indeed provide a genuine buffer in case of asset-quality deterioration.

Figure 8: percentage of loans classified in stage 2



Source: EBA, Scope Ratings

Figure 9: banks’ heterogenous approach to stage provisioning in 2020



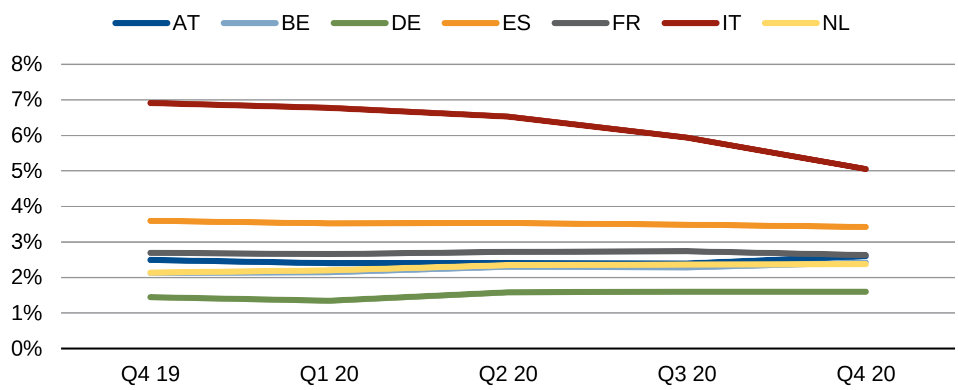
Listed banks are part of the bank sample shown in appendix. *Stage 3 or in relation to specific files. **No breakdown disclosed. Source: banks, Scope Ratings

Stable NPL ratios also reflect active balance-sheet management

Stage 3 loan ratios have remained well under control across the largest EU economies (Figure 9). This results from banks’ proactive efforts to reduce the stock of pre-crisis NPLs, notably in Italy. Active balance-sheet management explains why the EBA weighted average NPL ratio fell throughout the year (Figures 1and 9).

The increase of 2020 cost of risk did not systematically result in a similar increase of provisions against problem loans, meaning that banks actively wrote off problem loans. The counterbalancing effect of active balance-sheet clean-up strategies also explains the stability of NPL ratios.

Figure 10: percentage of stage 3 loans (impaired)



Source: EBA, Scope Ratings

Apart from sectors most sensitive to public-health measures shown in Figure 7, sensitivity to oil-price volatility, either directly or indirectly (e.g. shipping) was a material source of credit risk for banks in 2020. The performance of the construction and real estate sectors represents the next sector exposure to watch out for. They were severely hit during the global financial crisis and remain a source of legacy problem loans. Property prices are generally holding up well, but commercial real estate is more at risk than the residential sector due to changing working patterns. Supply-chain issues may also put pressure on the construction sector.

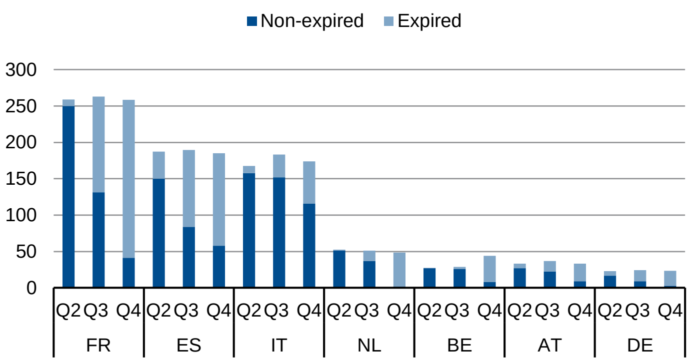
Residual loans under moratorium (not yet expired) could become a source of problem loans

Loans still under moratorium point to more fragile borrowers

So far, the performance of loans exiting moratorium has been comforting. Repayment according to schedule has been massive, moving from EUR 811bn in June 2020 down to EUR 318bn at end 2020. French and Spanish banks, which granted the largest share of moratoriums, have rapidly seen portfolios expire (Figure 11). The decision to extend moratoriums in Italy explains the larger amount of loans under non-expired moratoriums still outstanding.

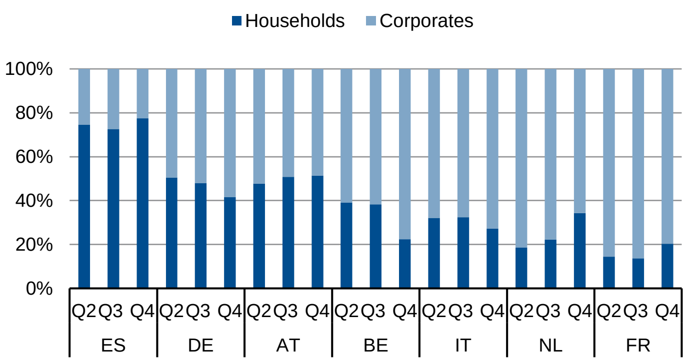
Banks have generally reported benign asset-quality metrics for loans under expired moratoriums. But the quality of the loans under moratorium will likely deteriorate as moratoriums expire. The borrowers that are still benefiting from moratoriums are likely to prove more fragile than those who exited the schemes earlier. Whether loans under moratorium are skewed towards households or corporates (Figure 12) will influence the overall performance of these loans.

Figure 11: expiry of EBA-compliant moratoriums (EU bn)



Source: EBA, Scope Ratings

Figure 12: distribution of moratoriums between households and corporates



Source: EBA, Scope Ratings

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 operating income over 2007-2020, highlighting the impact of the Covid-19 crisis in 2020 versus 2019

Chart E: cost of risk either as a percentage of annual pre-impairment operating income or as a percentage of customer loans

Charts B and C compare customer loans by stage (1, 2, 3) throughout 2020

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)

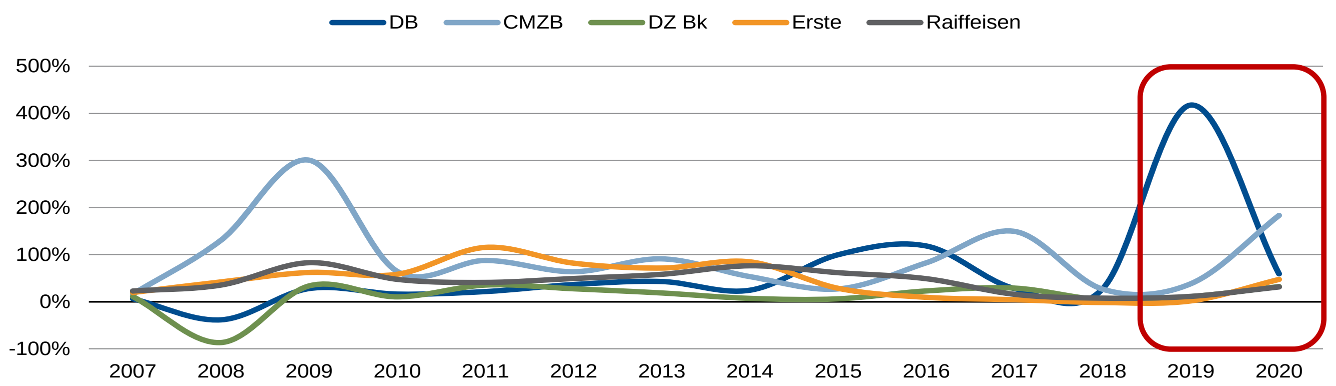
Coverage relative to stage 1 and stage 2 provisions (allocated at portfolio level)

Coverage taking into account loan-loss provisions and tangible equity (a measure of asset quality known as the '*Texas ratio*').

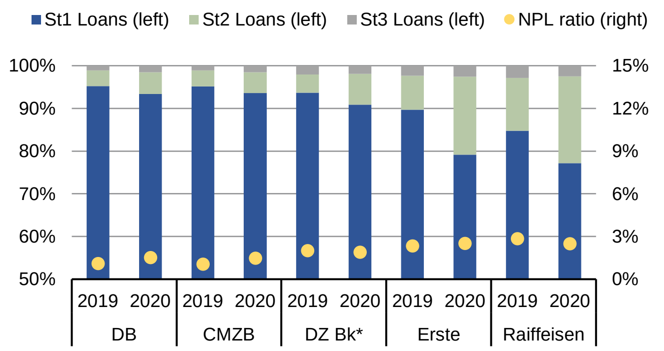
Austria and Germany

Long-term trends	Recent developments & emerging trends	Expectations
• Very liquid corporate sectors • Diversified and granular loan books • Corporate lending with low margins and modest credit costs	• Minor use of moratoriums or public support programmes • Significant hike in stage 2 loans, especially in CEE exposures, likely to gradually normalise in second half of 2021 and first half of 2022.	MODERATE pressure for Austrian banks (mostly due to CEE exposure) and LOW pressure for German banks given the resilience of the local economy

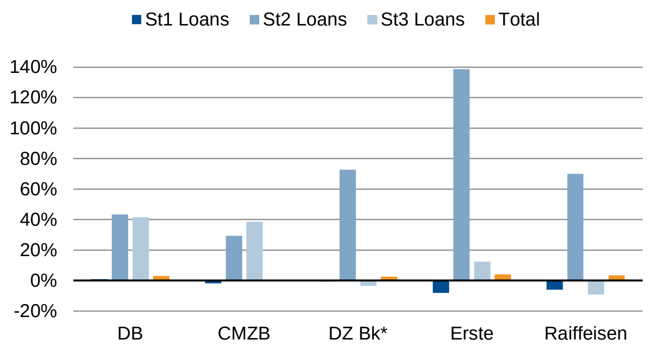
A. Credit impairment as % of pre-impairment operating profit (PIOP)



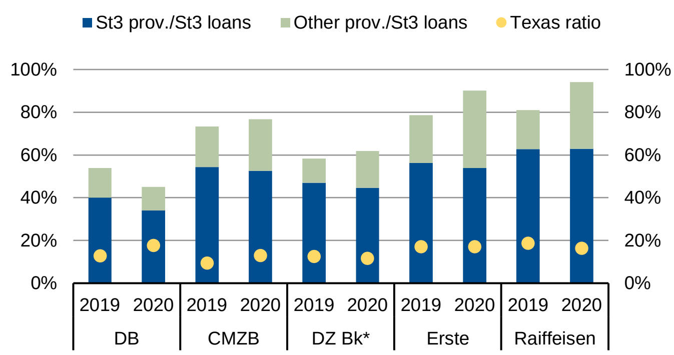
B. Breakdown of customer loans and NPL ratios (%)



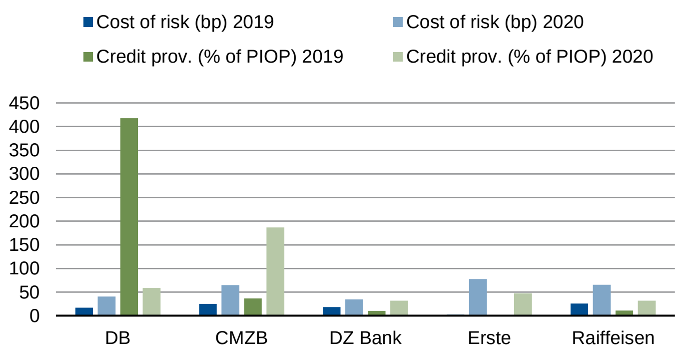
C. Customer loans by stage (%)



D. Coverage of Stage 3 loans



E. Credit cost



DB: Deutsche Bank; CMZB: Commerzbank; DZ Bank: DZ Bank AG, Erste: Erste Group; Raiffeisen: Raiffeisen Group. *DZ Bk: estimates assuming 95% of stage 2 and stage 3 financial assets at amortized cost and loss allowances relate to customer loans. Source: SNL, banks, Scope Ratings.

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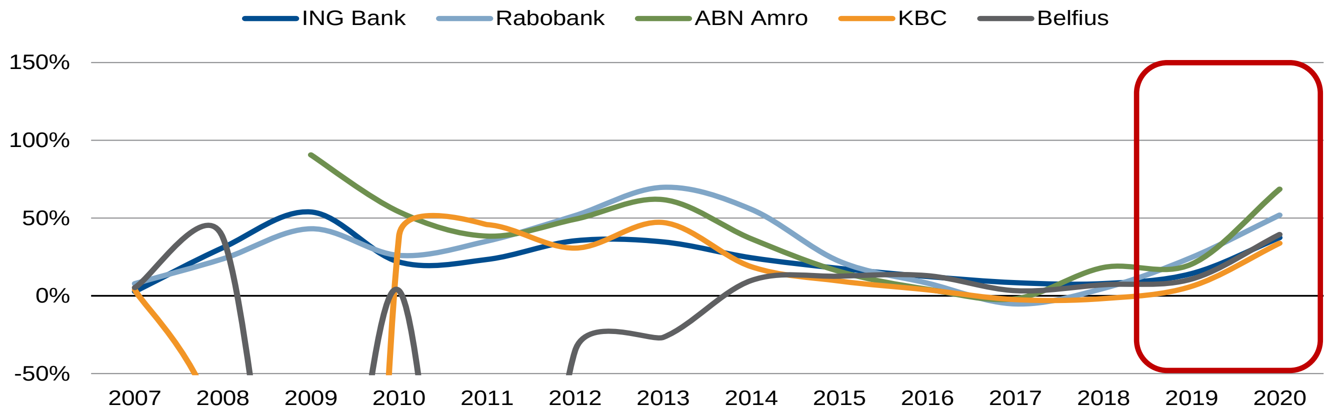
Belgium and The Netherlands

Long-term trends	Recent developments & emerging trends	Expectations
• Domestic mortgage portfolios due to reduce with the gradual shift from interest-only mortgages to amortising loans. Low interest rates on deposits also incentivised customers to accelerate mortgage repayments. • Dutch banks' tendency to lend against collateral explains why provisioning levels are lower than those of peers.	• Moderate increase in the cost of risk, largely driven by efforts to build precautionary provisions • Limited recourse to EBA-compliant moratoriums, and most beneficiaries already resumed payment according to schedule. • Limited recourse to ad hoc public guaranteed lending programmes.	MODERATE pressure on asset quality

A. Credit impairment as % of pre-impairment operating profit (PIOP)



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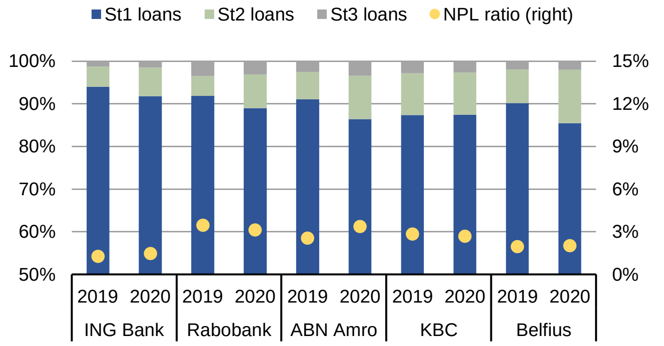
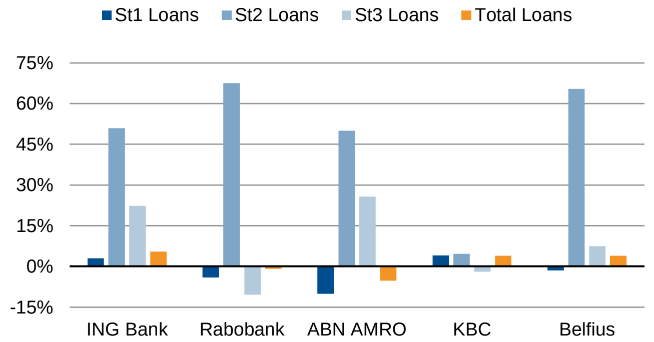


C. Customer loans by stage (%)



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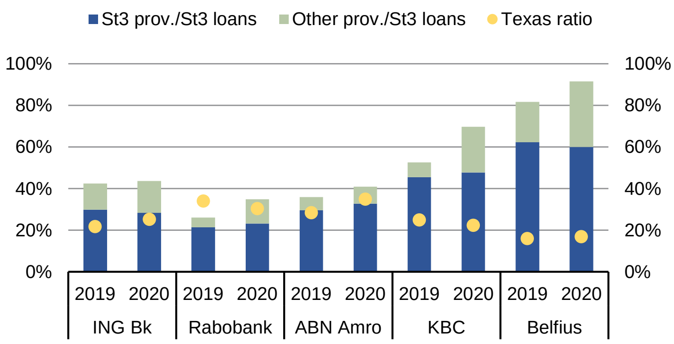
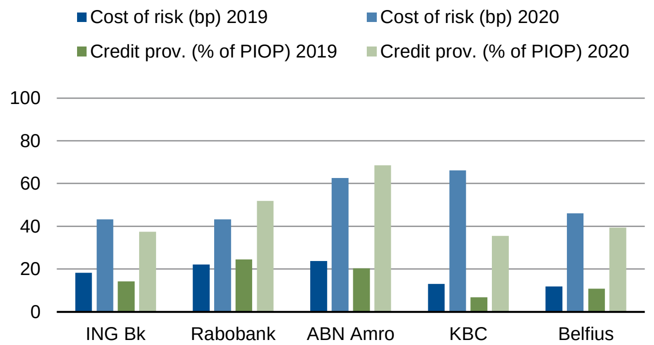


E. Credit cost

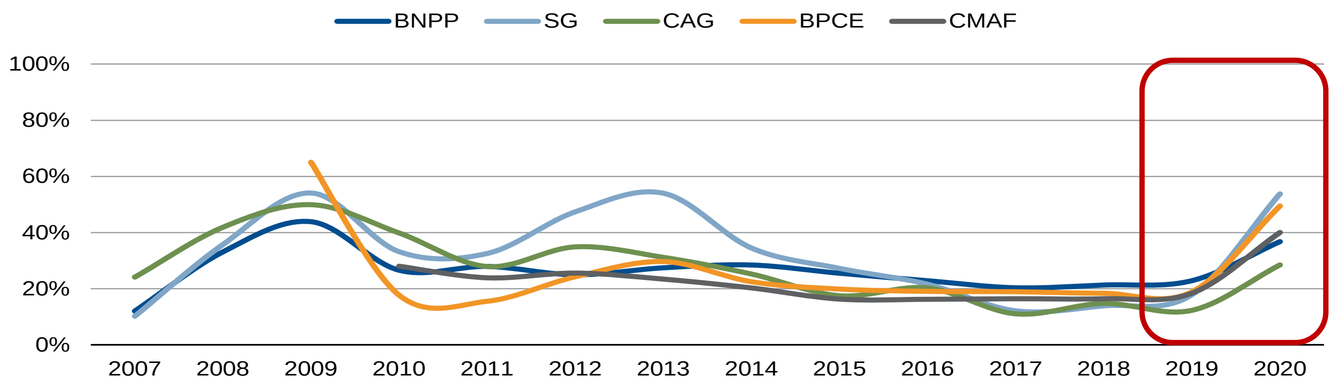


ING Bk: ING Bank; Rabobank: Cooperatieve Rabobank, ABN AMRO: ABN AMRO Bank; KBC KBC Group NV.Source: SNL, banks, Scope Ratings.

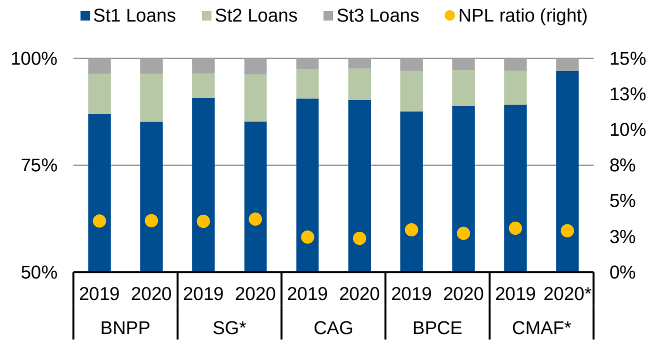
France

Long-term trends	Recent developments & emerging trends	Expectations
• Diversified and granular loan books • Conservative provisioning policies • NPL ratios in line with EU average	• Uninterrupted growth of customer loans due to a dynamic property market and a massive State-guaranteed loan programme (EUR 135bn outstanding) intended to boost corporate liquidity.	MODERATE pressure on asset quality

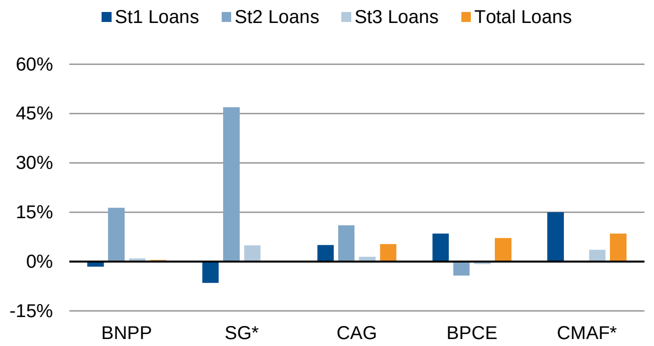
A. Credit impairment as % of pre-impairment operating profit (PIOP)



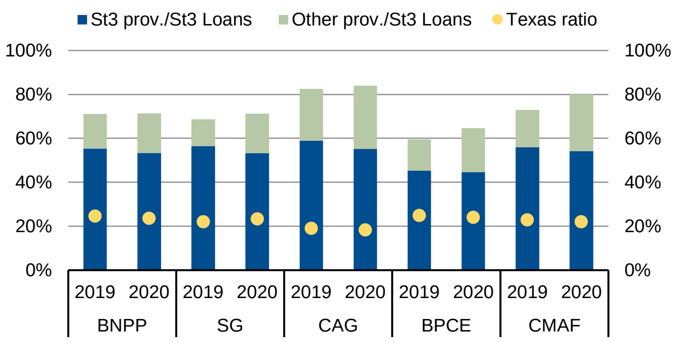
B. Breakdown of customer loans and NPL ratios (%)



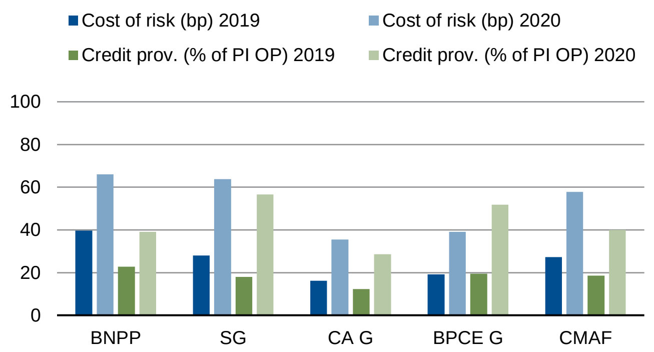
C. Customer loans by stage (%)



D. Coverage of Stage 3 loans



E. Credit cost

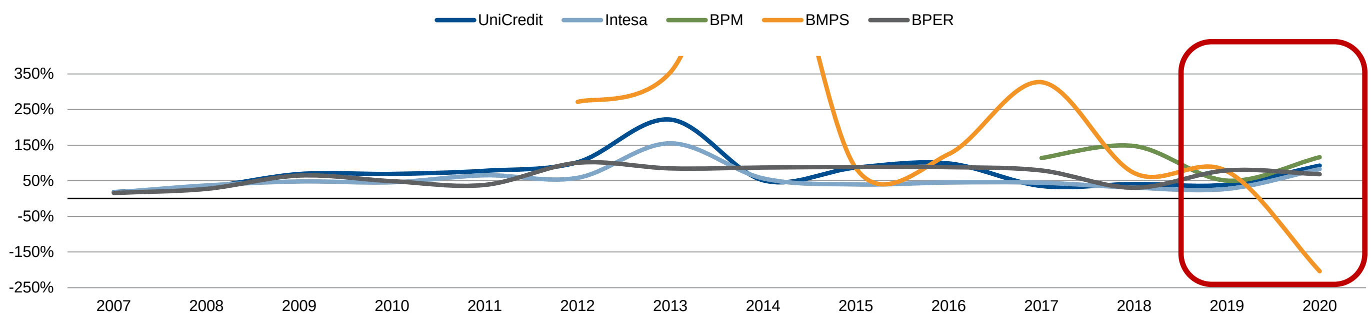


BNPP: BNP Paribas; SG: Société Générale; CAG: Crédit Agricole Group; BPCE: BPCE Group; CMAF: Crédit Mutuel Alliance Fédérale (part of Crédit Mutuel Group).
*SG: estimated evolution of stage 2 loans; CMAF: breakdown of stage 1 and stage 2 loans in 2020 not yet disclosed. Source: SNL, banks, Scope Ratings.

Italy

Long-term trends	Recent developments and emerging trends	Expectations
• High exposure to SME lending, traditionally riskier than secured retail loans and corporate financing • Secular improvement in credit origination • Lengthy NPL resolution processes • GACS securitisation proved to be an effective instrument to facilitate NPL sales and could be rolled over after 2022	• Ongoing de-risking of legacy NPLs • Increase in provisioning levels moderate – 2019 levels incorporated provisions for NPL disposals • High recourse to moratoriums (around 17% of total loans), with more than 50% still outstanding as of YE 2020. • Usage of hoc public guaranteed lending programmes to boost lending in 2020.	MODERATE pressure on asset quality: rising NPLs in 2021 and 2022, but manageable provisioning needs

A. Credit impairment as % of pre-impairment operating profit (PIOP)



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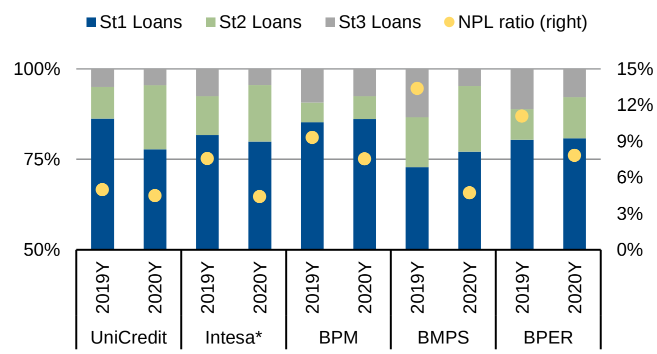

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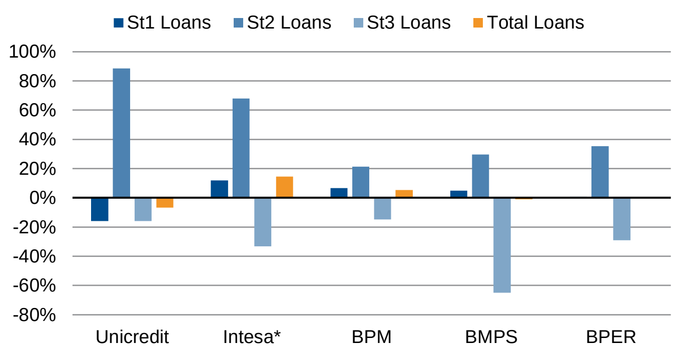

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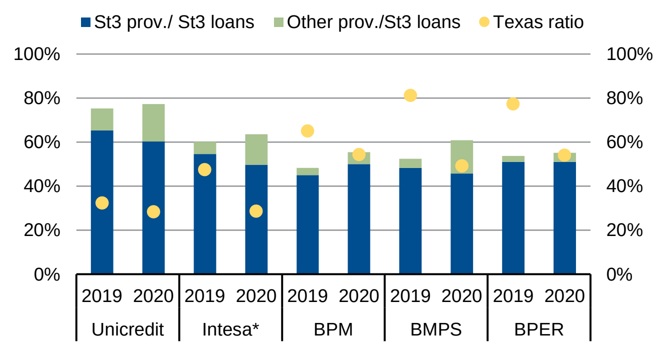

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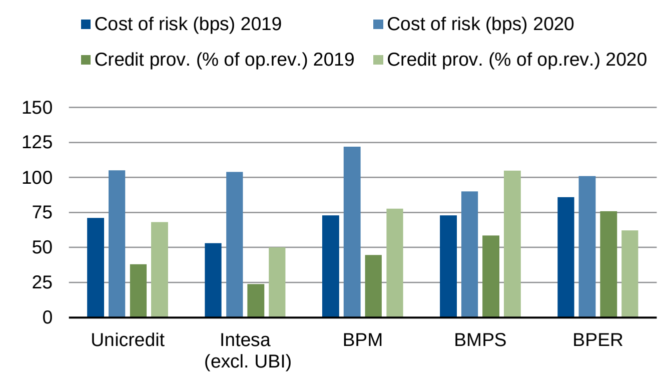
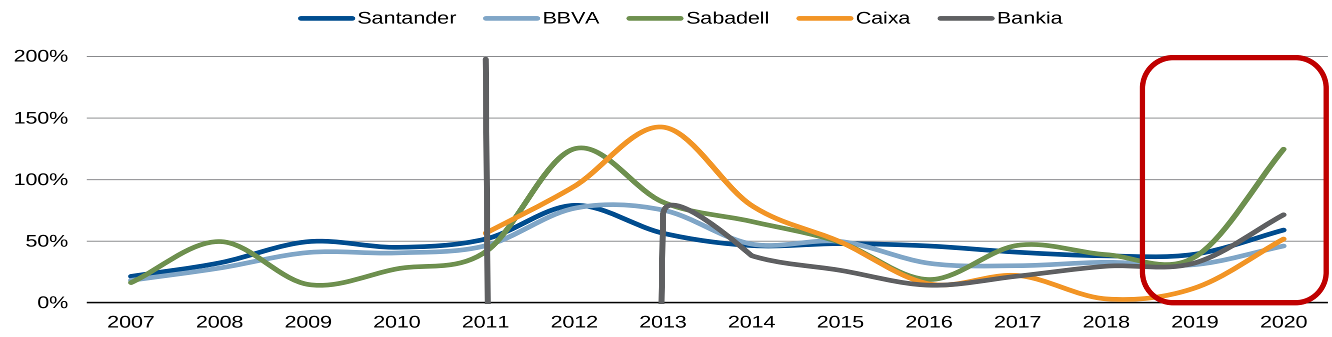


UniCredit: UniCredit SpA; Intesa: Intesa Sanpaolo SpA; BPM: Banco BPM; BMPS: Banca Monte dei Paschi di Siena SpA. *Intesa: data at end 2020 for charts A to D include UBI (following its merger with Intesa in the course of 2020). Source: SNL, banks, Scope Ratings.

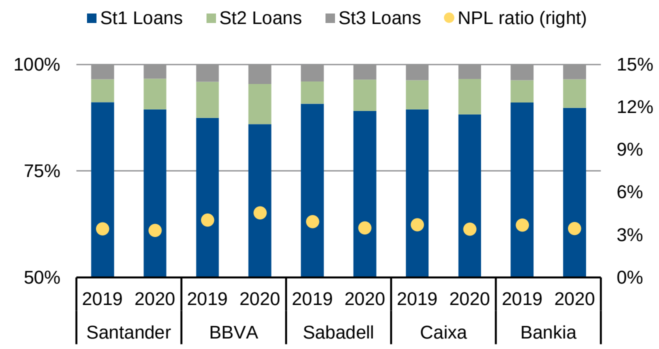
Spain

Long-term trends	Recent developments & emerging trends	Expectations
• Higher average NPL ratio than core EU peer countries • De-risking of non-performing loans taking more time than in other countries (namely Italy and Portugal) with material stock of legacy NPLs. • Most Spanish bank's loan books are tilted towards low-risk retail mortgages.	• Continuing de-risking, and higher coverage ratios (from 51.3% to 61.5%) • Material increase in the cost of risk in 2020 (+325% YoY for sample banks), mainly driven by worsening macroeconomic scenario. • Very limited access to both legal and sector moratoriums (4.1% of total loans on average for sample banks) but over 75% of it is still active. • Material recourse to government-guaranteed loans (EUR 116bn at end 2020) providing extra liquidity to corporates (especially SMEs).	MODERATE pressure on asset quality: NPLs will increase in 2021 once all the relief measures are lifted or end. Existing coverage of NPLs looks adequate at around 60% on average.

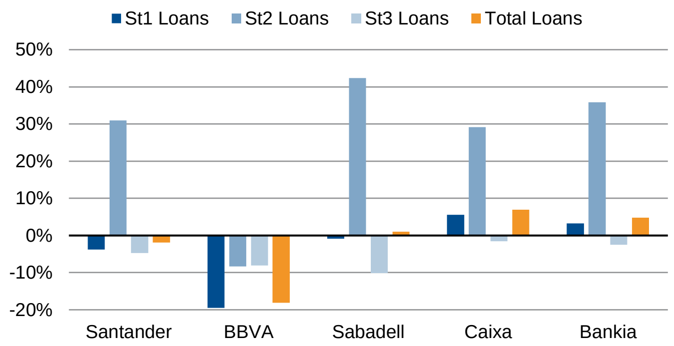
A. Credit impairment as % of pre-impairment operating profit (PIOP)



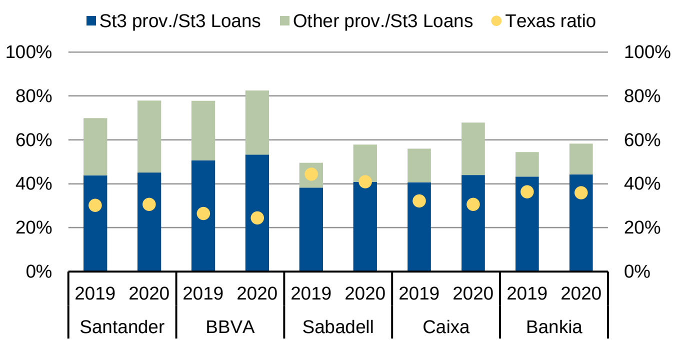
B. Breakdown of customer loans and NPL ratios (%)



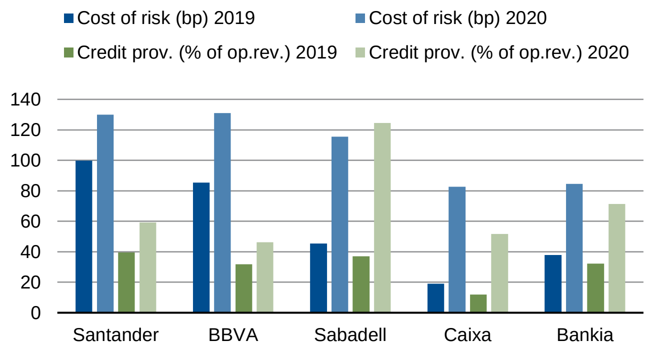
C. Customer loans by stage (%)



D. Coverage of Stage 3 loans



E. Credit cost



Santander: Banco Santander; BBVA: Banco Bilbao Vizcaya Argentaria (movements highlighted in chart C mainly reflect sale of US activities); Sabadell: Banco de Sabadell; Caixa: CaixaBank. Source: SNL, banks, Scope Ratings.

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