Non-performing exposure tracker – Q2 2021

Shining a light on European lending

Building a better working world

Banks continue to keep non-performing exposures (NPEs) at manageable levels, helped by disposals. However, the credit outlook remains uncertain and the disruption effects of the pandemic are still to come in the coming quarters.

The EY NPE tracker is a quarterly publication that aims to monitor key developments in European credit and NPE markets during the current downturn and beyond.

The tracker draws on data from European regulators and supervisors, quantitative data from other credible sources, and EY teams' engagement with a wide range of clients (see methodology below for details).

Exhibit 1 – European NPL heatmap summary: most major markets are relatively stable

	Loans volumes		Loan distribution among stages – stage 2 vs. stage 3 (IFRS9)		NPL stock YTD (€b)		NPL ratio YTD (%)			Loans under moratoria (YTD)		Loans with public guarantee (YTD)	
Country	Total loans YTD (€b)	Total new loans YoY YTD (%)	Stage 2: Q2-21 vs. Q2-20 YTD (%)	Stage 3: Q2-21 vs. Q2-20 YTD (%)	NPL stock Q2-21 (€b)	NPL stock YoY Q2-21 (%)	Historical max (%)	Q2-21 (%)	Q2-21 vs. Q1-20 absolute change (%)	Amount (€b)	% of total loans	Amount (€b)	% of total loans
Cyprus	33	20.1%	22.2%	-35.5%	3.0	-29.7%	38.9%	9.1%	-6.4%	0.0	0.1%	0.0	0.0%
Germany	2,808	9.8%	18.0%	-10.3%	31.2	-7.8%	1.9%	1.1%	-0.1%	1.0	0.0%	12.7	0.5%
Spain	2,653	11.4%	21.3%	-5.8%	83.1	4.9%	4.5%	3.1%	0.1%	22.2	0.8%	106.8	4.0%
France	5,740	5.5%	16.3%	-5.9%	118.1	-6.7%	3.1%	2.1%	-0.3%	7.1	0.1%	118.9	2.1%
Greece	205	-2.6%	-3.2%	-49.8%	30.4	-50.5%	45.3%	14.8%	-15.5%	1.4	0.7%	5.6	2.7%
Ireland	256	14.9%	11.3%	-4.4%	8.6	-0.4%	10.5%	3.4%	-0.7%	0.5	0.2%	1.2	0.5%
Italy	1,991	7.3%	17.9%	-30.8%	74.0	-31.7%	11.1%	3.7%	-2.3%	36.5	1.8%	110.7	5.6%
Netherlands	1,959	5.8%	-20.5%	-10.0%	33.5	-11.2%	2.4%	1.7%	-0.3%	0.7	0.0%	3.2	0.2%
Poland	124	3.3%	34.2%	-1.9%	6.4	4.6%	6.8%	5.2%	0.3%	0.3	0.2%	3.5	2.9%
Portugal	209	-16.2%	25.6%	-21.7%	8.8	-37.9%	15.2%	4.2%	-1.5%	27.0	2.9%	7.1	3.4%
EU/EEA	19,227	5.8%	7.9%	-19.2%	442.2	-16.3%	4.1%	2.3%	-0.6%	123.4	0.6%	377.3	2.0%

Source: European Banking Authority Q2 2021, NPL markets

NPL (Non-performing loans) outlook and risk level

Negative: high | Watchlist: medium | Stable: low

This edition of the tracker focuses on four key findings:

1. Asset quality appears to have stabilized, but further problems could still emerge

Data on international financial reporting standards (IFRS) loan categories shows that European banks' stage 2 loans (performing, but with increased risk) grew by 7.9% YoY in Q2-21, although Q2 itself saw a slight decrease of 1.5% (see exhibit 4). As shown in Exhibit 4, Spain, Cyprus, Portugal and Poland saw YoY increases from 21% to 34%, while Germany, Italy and France grew in the range of 16%-18%. On the other hand, the Netherlands and Greece saw their stock of stage 2 loans decrease on a YoY basis.

Stage 2 loans represented 8.8% of all loans and advances to non-financial customers at the quarter-end. In contrast, stage 3 loans (those that are impaired) decreased by 8.8% YoY, including a decline of 1.0% in Q2, to reach 2.8% of all non-financial loans and advances at the end of the quarter. However, some countries experienced a significant increase in Q2, such as Poland (5.9%) and Spain (1.6%). As discussed in Section 3 below, we also note that loans still under moratoria could be concealing potential increases in risk.

2. Loan loss levels are predicted to keep falling, but we still expect banks to face increasing pressure in coming quarters

Exhibit 2 — European banks' NPE outlook is positive for now (reporting season Q3-21)

Bank	Country	NPL expected inflows	Cost of Risk
Bank 1	Spain	Stable	Higher
Bank 2	Spain	Higher	Lower
Bank 3	Spain	Higher	Higher
Bank 4	UK	Higher	Lower
Bank 5	UK	Lower	Lower
Bank 6	UK	Higher	Higher
Bank 7	Italy	Lower	Lower
Bank 8	Italy	Lower	Lower
Bank 9	Italy	Lower	Higher
Bank 10	France	Higher	Lower
Bank 11	France	Higher	Lower
Bank 12	France	Lower	Lower
Bank 13	Germany	Lower	Lower
Bank 14	Germany	Stable	Higher
Bank 15	Ireland	Stable	Stable
Bank 16	Greece	Lower	Higher
Bank 17	Netherlands	Lower	Lower
Bank 18	Netherlands	Lower	Lower
Bank 19	Austria	Higher	Lower
Bank 20	Nordics	Higher	Lower
Bank 21	Poland	Stable	Lower

ECL: Expected credit losses. ECL trend corresponds to the quarterly change of loan-loss provisions reported by European banks in the sample.
Source: EY analysis Q3 2021.

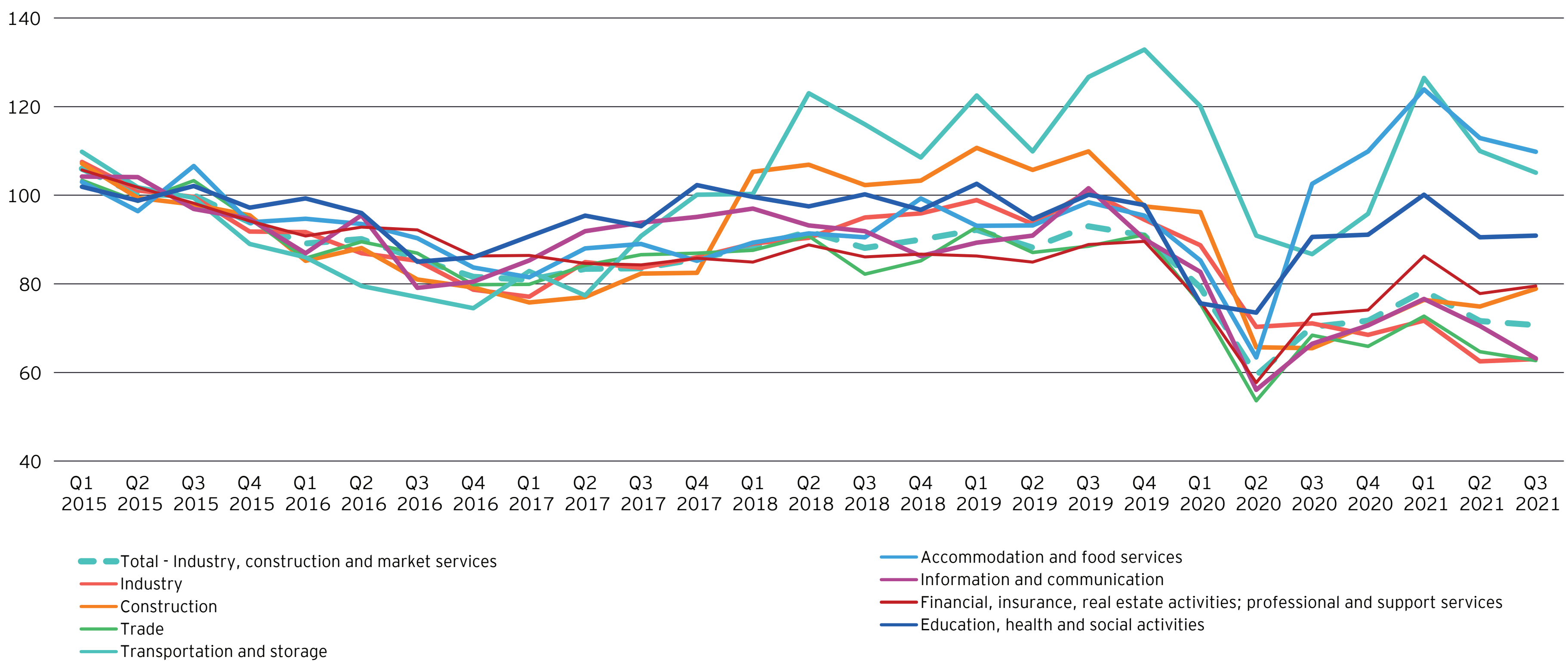
European banks' NPL ratios show a similar picture to the IFRS data (see exhibit 1). Aggregate European NPL ratios, which climbed to 3.0% during 2020, fell back during the first half of the current year, reaching 2.3% at Q2-21.

To better understand European banks' NPE consensus, EY teams have conducted an exercise to review banks' earnings calls transcripts for Q3-21 (see methodology for details). This research suggests that the asset quality situation remained on a knife-edge during the first three quarters of 2021 (see exhibit 2) and in line with our previous analysis in Q2.

More specifically:

- A number of European banks have lowered their short-term expectations of NPL formation, but Q3-21 also saw several banks in Spain, France and the UK slightly increase their expectations for new NPL inflows compared to our previous analysis for Q2-21. And while many banks reported lower NPL ratios at Q3-21, some saw NPLs as stable, and a few institutions saw NPL ratios increase.
- A combination of lower provisions and broadly stable NPL ratios meant that the number of banks reporting lower NPL coverage ratios exceeded those with increasing levels of coverage.
- Most European banks in the sample (14 out of 21) experienced slightly lower costs of risk during Q3-21 thanks to the enhanced economic outlook. Some banks maintained their provisioning levels while others reduced them slightly, and only a few increased provisions in Q3-21. Loan loss provision levels are expected to continue declining for almost all banks. However, the end of loan moratoria and other government measures does mean that we expect the coming quarters to see European banks come under growing pressure, including higher costs of risk.

Exhibit 3 — European declarations of bankruptcies are climbing in some sectors



Source: Eurostat Q3 2021

In short, European banks' potential credit losses continue to remain on hold, with moratoria and government support largely ensuring that defaults have yet to materialize.

The question now is how different sectors of the economy will respond to evolving circumstances and the withdrawal of government assistance. Commercial bankruptcies are one potential indicator. These trended down in the years before the pandemic and fell steeply in Q2-20 as moratoria and guarantees were announced. However, business failures increased in Q3-20 have trended upwards since. Bankruptcies grew in almost all sectors economy during the first quarter of 2021 (especially in accommodation and food, transport and storage, and social activities) and although the overall number of business failures decreased slightly in Q3-21, it grew among industrial, construction and finance and insurance companies.

Exhibit 4 — Loan composition by stages Q2-21: Stage 2 loans are clearly growing

Country	Stage 1	QoQ	YoY	Stage 2	QoQ	YoY	Stage 3	QoQ	YoY
Cyprus	68.4%	4.2%	7.7%	17.1%	-0.2%	22.2%	14.5%	-0.6%	-39.6%
Germany	90.2%	1.2%	-1.2%	8.4%	-10.2%	18.0%	1.4%	-3.1%	15.5%
Spain	89.3%	0.3%	-1.2%	7.4%	-1.5%	21.3%	3.3%	1.6%	-1.4%
France	89.0%	0.0%	-1.1%	8.5%	1.5%	16.3%	2.6%	1.1%	0.2%
Greece	69.6%	25.0%	33.6%	13.2%	-3.6%	-3.2%	17.2%	1.2%	-17.8%
Ireland	79.1%	-0.2%	-1.8%	16.2%	2.3%	11.3%	4.7%	-8.6%	30.0%
Italy	82.1%	0.5%	0.0%	13.4%	0.6%	17.9%	4.5%	-0.9%	-26.1%
Netherlands	90.9%	0.4%	2.3%	7.0%	-3.1%	-20.5%	2.1%	-4.1%	3.5%
Poland	82.3%	0.9%	-3.7%	12.8%	-1.9%	34.2%	4.9%	5.9%	12.7%
Portugal	83.1%	0.1%	-1.2%	11.9%	2.6%	25.6%	5.0%	-5.0%	-16.7%
EU/EEA	88.4%	0.5%	0.0%	8.8%	-1.5%	7.9%	2.8%	-1.0%	-8.8%

Source: European Banking Authority Q2-21

Stage 1: >85% >75%->=85% <=75%

Stage 2: <=10% >10%->=15% >15%

Stage 3: <=3.5% >3.5%->=7.0% >7.0%

3. Moratoria and guarantees have been extended and could carry higher potential risks

Most moratoria and public guarantee schemes in many European countries, including key markets such as Italy, France and Spain, will expire at the end of 2021 or have been extended until the first half of 2022.

Loans under the European Banking Authority (EBA) eligible moratoria have continued to decline, reaching €123b in Q2-21. Set against that, it is notable that stage 2 credits make up 28.2% of these loans. That is not only higher than the level of stage 2 loans among all banking loans and advances (8.8%) but also than for loans under expired moratoria (24.4%). This implies that loans still under moratoria could be carrying higher levels of potential risk.

Loans under public guarantee schemes remained flat at €377b in Q2-21, with France, Spain and Italy accounting for the largest balances. The share of stage 2 loans within this portfolio increased to 18.5% from 13.6% in Q1, again higher than the average level of 8.8%.

4. NPLs have fallen, but look likely to increase

Across Europe, aggregate NPL ratios fell to 2.3% in Q2-21, a quarterly decrease of 20bps that continued the trend seen since Q1-20. Nationally, NPL ratios in Q2-21 were at their highest in Greece (14.8%) and Cyprus (9.1%) although both were significantly lower than at the end of 2020, when they stood above 30% and 15%, respectively (see exhibit 5).

In fact, most major markets except Spain saw NPL ratios decline or remain stable during Q2-21. NPL sales continue to be a major factor, with many countries heavily affected by the financial crisis of 2008 — including Greece, Italy, Cyprus and Portugal — seeing further NPL disposals during the year. The four countries with the largest absolute stock of NPLs at Q2-21 were France (€118b), Spain (€83b), Italy (€74b) and Greece (€30b).

In our view, the strong recovery of European economies experienced in 2021 has set aside, for the moment, the most severe credit scenarios. However, we do expect an inevitable surge of new NPL inflows across European banks' balance sheets once moratoria and support measures come to an end. Given the remaining legacy stock of NPLs from the last financial crisis, banks will need to take a proactive approach, monitoring and anticipating new inflows as well as enhancing their NPL deleveraging strategy with new asset types, if they are to avoid NPL volumes becoming unmanageable.

Exhibit 5 — NPL ratio heatmap: risk is concentrated in key markets and asset types

Asset type	Cyprus	Germany	Spain	France	Greece	Ireland	Italy	Netherlands	Poland	Portugal	EU/EEA
NPL ratio	9.1%	1.1%	3.1%	2.1%	14.8%	3.4%	3.7%	1.7%	5.2%	4.2%	2.3%
Households	19.5%	1.6%	3.8%	2.5%	23.0%	4.7%	3.7%	1.2%	4.2%	2.7%	2.7%
Mortgage	19.6%	0.9%	3.1%	2.3%	19.9%	4.5%	2.8%	0.9%	2.3%	1.6%	2.1%
NFC	14.4%	2.5%	5.1%	3.9%	20.2%	6.7%	6.8%	4.2%	7.5%	9.1%	4.4%
SME	16.1%	2.8%	7.3%	4.3%	29.9%	10.4%	9.3%	5.2%	8.8%	9.4%	5.7%
Commercial real estate	13.0%	2.1%	10.3%	3.6%	34.4%	12.2%	12.5%	5.0%	11.3%	14.3%	5.9%

Source: European Banking Authority Q2-21

Negative: high Watchlist: medium Stable: low

On average, NPL ratios for loans to non-financial companies (4.4% in Q2-21) are higher than for loans to households (2.7%). Within the NFC category, NPL ratios for SME loans (5.7%) and commercial real estate loans (5.9%) are particularly elevated. And while NPL ratios fell for most sectors of the economy during Q2-21, it is notable that they increased materially in accommodation and food (from 9.0% to 9.7%) and in arts, entertainment and recreation (from 7.9% to 8.2%).

Given the continued economic stress and renewed lockdowns in many European markets during 2021, it seems likely that the withdrawal of support measures will lead to a subsequent increase in NPL ratios during the second half of 2021 and into 2022, especially in more vulnerable sectors.

Conclusion

Banks continue to keep NPEs at manageable levels, helped by disposals. However, the credit outlook remains uncertain, and the disruption effects of the pandemic are still to come in the coming quarters.

1. Asset quality appears to have stabilized, but further problems could still emerge.
2. Loan loss provisions are predicted to keep falling, but we still expect banks to face increasing pressure in coming quarters.
3. Moratoria and guarantees have been extended and could carry higher potential risks.
4. NPLs have fallen but look likely to increase.

Looking ahead, the prospect of an end to payment moratoria and public guarantees could mean that the end of 2021 and first half of 2022 will see a downturn in European credit conditions. However, this is likely to vary significantly between different markets and sectors, and these details will determine which areas see the greatest level of transaction activity.

NPE tracker methodology

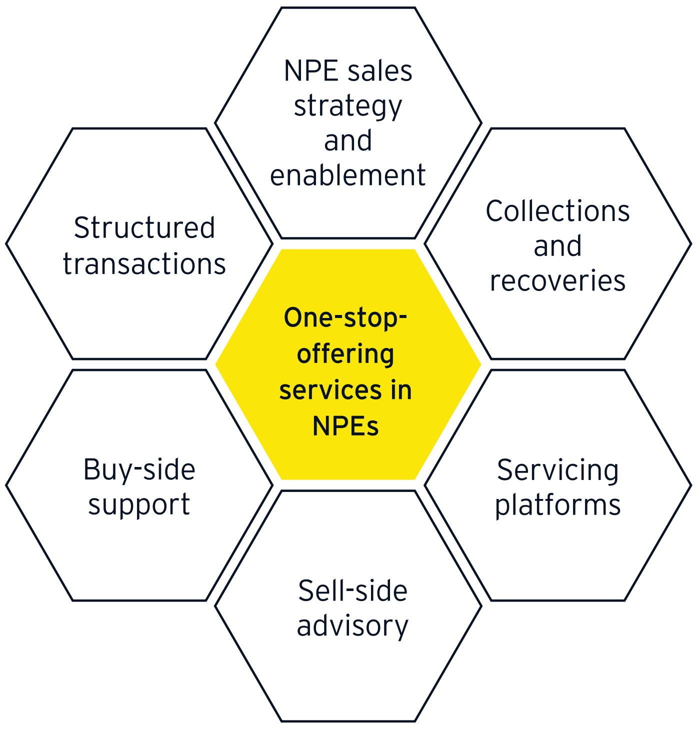
1. The NPE tracker's main source of data is the EBA risk dashboard that summarizes the main risks and vulnerabilities in the banking sector in the European Union (EU) by looking at the evolution of Risk Indicators (RI) among a sample of banks across the EU.
2. From the EBA risk dashboard, EY teams have analyzed aggregate data (at a country level) on a quarterly basis on key issues relating to credit lending origination, asset quality, provisions (including distribution among stages according to IFRS 9), NPL ratios, moratoria programs, public guarantee schemes, and the overall macroeconomic situation.
3. In addition, to follow the impact that the pandemic is having on European banks, we have tracked earnings call transcripts for 21 European banks to identify banks' current views in terms of NPLs/NPEs, asset quality performance, stage provisioning and NPL formation/deleveraging.

The banks' sampling selection has been as follows:

- Top #3 banks in terms of total assets for each of the following key NPL core markets (France, Italy, Spain, the UK)
- Top #2 banks in terms of total assets in Germany and the Netherlands
- Top #1 banks in terms of total assets in Austria, Ireland, Greece, Poland and The Nordic Region

How EY teams can help

- EY teams combine transactional experience with strategic advice to support banks, credit investors and regulators in developing and helping implement key operational and cost-reduction strategies for bank deleveraging, loan portfolio management and financial stability safeguarding.
- We have a strong internal network, breadth of knowledge and vast array of credentials covering different macroeconomic landscapes.



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