Non-performing exposures tracker Q3 2022

Shining a light on European lending

Are inflation and interest rates starting to have an impact on banks' asset quality?

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

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: NPL stocks continue to decrease but Stage 2 loans are growing

	Loan volumes		Loans in Stage 2 (IFRS9)			NPL stock		NPL ratio			Loans with public guarantee	
Country	Total loans (€b)	Total new loans YoY (%)	Stage 2 stock 3Q22 (€b)[1]	3Q22 (%)	Stage 2: 3Q22 vs 3Q21 (%)	NPL stock 3Q22 (€b)	NPL stock YoY 3Q22 (%)	5 Year Historical max (%)[2]	3Q22 (%)	3Q22 vs. 3Q21 abs change (%)	Amount (€b)	% of total loans
EU/EEA	**20,890**	**+6.9%**	**1,981.3**	**9.5%**	**+0.8%**	**367.4**	**-12.4%**	**3.8%**	**1.8%**	**-0.4%**	**349.1**	**1.7%**
France	6,077	+3.5%	624.8	10.3%	+1.7%	109.6	-5.4%	3.0%	1.8%	-0.2%	98.9	1.6%
Spain	2,905	+8.7%	192.3	6.6%	-0.6%	79.0	-3.2%	4.5%	2.7%	-0.3%	93.9	3.2%
Italy	2,008	+0.1%	262.5	13.1%	+0.5%	51.2	-28.2%	10.8%	2.6%	-1.0%	120.7	6.0%
Germany	3,094	+9.1%	321.2	10.4%	+2.3%	30.7	-1.0%	1.7%	1.0%	-0.1%	10.4	0.3%
Netherlands	2,172	+7.9%	161.2	7.4%	+0.7%	26.5	-16.0%	2.3%	1.2%	-0.3%	3.1	0.1%
Greece	225	+11.0%	27.5	12.2%	-1.1%	11.0	-48.1%	45.3%	4.9%	-5.6%	4.7	2.1%
Portugal	228	+5.7%	22.6	9.9%	-2.4%	7.2	-14.3%	13.6%	3.1%	-0.7%	7.2	3.2%
Ireland	301	+14.5%	34.8	11.6%	-3.8%	6.1	-23.7%	8.2%	2.0%	-1.0%	0.8	0.3%
Poland	136	+9.8%	16.1	11.8%	-0.4%	5.8	-7.3%	6.8%	4.2%	-0.8%	4.7	3.5%
Cyprus	35	+6.0%	4.9	14.1%	-2.5%	1.1	-51.1%	38.9%	3.2%	-3.7%	0.0	0.0%

Notes:
(1) Stage 2 stock has been calculated using Stage 2 % multiplied by the gross loans and advances at amortized cost as provided by the EBA
(2) Countries in order of NPL stock - 5 year max for the period 2017 to 2022

Negative: high | Watchlist: medium | Stable: low

Source: EBA 2Q22

This edition of the tracker focuses on four key findings:

1. Macroeconomic challenges are showing through provisions

Banks are continuing to lend, with new European loans growing by 6.9% year-on-year during the first nine months of 2023. According to the latest EY European Bank Lending Economic Forecast, bank lending across the eurozone is expected to contract by 1.8% in 2023, the first decline since 2014, as eurozone economies slip into recession. Germany and Italy are forecast to see the steepest declines in net bank lending in 2024, of 1.7% and 1.8% respectively, principally due to the economic impact of high energy prices. Demand for loans is expected to fall across the region, and banks are also predicted to tighten their lending criteria in response to rising interest rates and a volatile economic outlook.

Consumer and business confidence levels remain near to record lows in many countries, and European economies continue to be negatively affected by the the war in Ukraine. At the time of writing, the European Commission forecasts economic growth of 3.5% in 2022 (above the 3.5% Autumn 2022 forecast) and 0.8% in 2023 (up from the 0.3% previously expected). Annual average EU inflation is projected to peak at a historic high of 9.3% in 2022, before easing slightly to 7% in 2023 (far higher than predicted in the summer).

Eurozone bank lending to businesses is expected to have grown by 4.8% in 2022. Excluding 2020, when pandemic support measures distorted lending figures, this would be the fastest rise since 2008. However, some of this demand is linked to the need for liquidity rather than investment and growth. Net lending to business is forecast to contract 2.7% in 2023, which would be the weakest performance in a decade. This reflects the economic impact of higher borrowing costs, supply chain disruption and rising costs. However, business lending is forecasted to grow again by 3.1% in 2024 and 3.9% in 2025 as economic conditions improve.

Based on our review of European Banks' results (see Exhibit 2), banks have maintained provisioning overlays with regards to Russian exposures and ongoing macroeconomic uncertainties. In addition, we believe that provisions could move higher in the short term if economic recovery takes longer than expected.

2. Europe's Stage 2 classified loans have trended upward from last year's level

Data on international financial reporting standards (IFRS) loan categories shows that European banks' Stage 2 loans (those performing but with increased risk) amount to €1,981.3b or 9.5% of total loans in Q3-22. This is similar to the previous quarter, but it represents a year-on-year (YoY) increase of 0.8 percentage points – reversing the decreasing trend seen throughout 2021 and exceeding the previous peak of 9.1% in Q4-20.

Quarter-on-quarter (QoQ), key European markets show some variations in Stage 2 ratios. France and Spain saw no change; Ireland (+0.6%) and the Netherlands (+0.6%) experienced growth; while Portugal (-2.0%), Cyprus (-1.5%), Italy (-0.5%), Greece (-0.5%), Germany (-0.4%) and Poland (-0.3%) all saw falls in Stage 2 ratios.

In contrast to Europe's Stage 2 loans, the region's overall stock of NPLs is falling. The ratio of Stage 3 loans (those that are non-performing) decreased by slightly less than 0.1% QoQ and fell by 0.5% YoY, as shown in Exhibit 4 below. It's also notable that YoY comparators show an average decrease of 12.4% in NPL stocks across Europe.

It is fair to say that some of the growth in Stage 2 loans may be driven by accounting classification triggers, not necessarily managerial decisions that reflect true credit quality deterioration. Even so, the YoY growth in Stage 2 loans implies a need for banks to sharpen their loan portfolio management. It also points to the potential for more market-oriented actions such as securitization – especially if the macroeconomic landscape continues to deteriorate.

Stage 2 allocation sentiment – EY's market conversations

Based on our conversations with risk professionals, the material increases in Stage 2 loans seen in recent years is mainly due to overlays applied by banks trying to interpret signs of potential difficulty.

It has been suggested that countries with automatic wage indexation, like Belgium, have experienced lesser levels of probability of default (PD) migration and NPL formation – helping to maintain the asset quality of mortgages and consumer loans. However, potential difficulties could merely be delayed, since businesses not only face increased energy costs but also higher salaries, which they may in turn pass on to the economy through higher prices.

Banks in other countries (e.g., Spain), are focusing on assessing affordability, using new metrics tailored to different sectors. Innovative analytics and tools, based on transactional and sectoral data, are also being used to predict clients' ability to pay.

Overall, risk professionals see recent events as having had limited effects on individuals and small and medium-sized enterprises (SMEs) so far. Factors that could trigger potential customer difficulties in the future - although no tangible evidence of this yet exists – include the effect of higher interest rates on large portfolios of floating rate loans (as in Finland).

3. European banks' asset quality sentiment is declining, based on the latest market communications, and we expect continued pressure in future quarters

In line with our previous reports, EY teams have reviewed European banks' earnings call transcripts for Q3-22 and Q4-22 (see methodology for details) to better understand their views on credit markets and NPE volumes.

The overall message from our research is that most European banks have mixed views about the direction of NPL inflows in the short-term, but that many see costs of risk rising. Separate EY research also predicts higher loan losses in the years ahead. More specifically:

- European banks' NPL outlooks vary, as illustrated by Exhibit 2. Polish, Nordic, German, Dutch and UK banks have the greatest short-term expectation of increasing NPLs. Banks in France are also ringing alarm bells. In contrast, the Spanish, Italian, Greek and Austrian banks that predicted higher NPL inflows earlier in the year now expect a better outlook, after cautiously increasing provisions in Q1-22. According to the credit conditions survey conducted by the Bank of England in Q4-22, UK lenders saw default rates on secured household lending remain stable QoQ but expect defaults to increase in Q1-23 for secured, unsecured and corporate lending to businesses of all size.
- Turning to mortgages, approvals in the UK fell by c.50% during 2022. Tighter regulation and lending criteria introduced after 2008 should mean borrowers are better able to deal with higher rates, while savings built up during the pandemic are likely to give households a cushion against falling incomes. On the corporate side, government-backed pandemic loan schemes, which tended to offer generous repayment terms, should also limit the rise of non-performing business loans, at least in the short-term.
- Even so, many banks across the UK, Spain and Italy appear to be experiencing a quarterly increase in cost of risk. Exceptions include a large Polish bank experiencing lower costs of risk despite expectations of continued double-digit inflation and weaker GDP growth in 2023.
- Higher loan losses are expected as a weaker economy and higher borrowing costs push up impairments on all forms of lending. EY's European Bank Lending Forecast predicts Eurozone loan losses to rise to 2.6% in 2022, up from 2.2% in 2021, and to slowly climb further in 2023 (3.3%), 2024 (4.2%) and 2025 (5%) although this would still be much lower than the 8.4% seen in 2013.

Exhibit 2 — European banks' NPL outlook is finely balanced, with downside risks (reporting season Q4-22)

Bank	Country	NPL expected Inflows	Cost of risk
Bank 1	Spain	Higher	Lower
Bank 2	Spain	Lower	Higher
Bank 3	Spain	Lower	Higher
Bank 4	UK	Higher	Higher
Bank 5	UK	Lower	Lower
Bank 6	UK	Stable	Higher
Bank 7	Italy	Lower	Higher
Bank 8	Italy	Lower	Higher
Bank 9	Italy	Lower	Higher
Bank 10	France	Lower	Stable
Bank 11	France	Higher	Lower

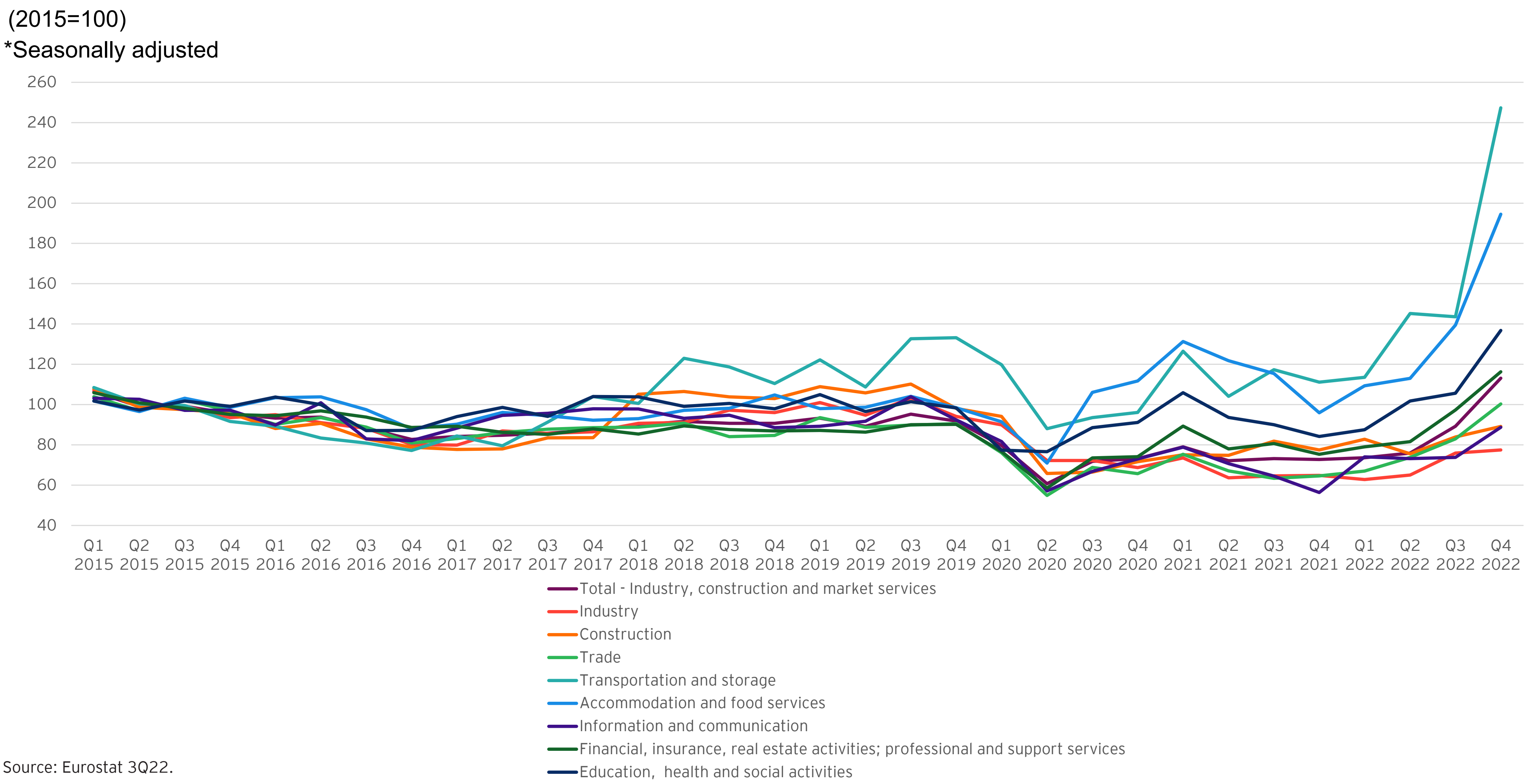
Bank	Country	NPL expected Inflows	Cost of risk
Bank 12	France	Higher	Higher
Bank 13	Germany	Higher	Stable
Bank 14	Germany	Higher	Higher
Bank 15	Ireland	Lower	Lower
Bank 16	Greece	Lower	Higher
Bank 17	Netherlands	Higher	Higher
Bank 18	Netherlands	Stable	Higher
Bank 19	Austria	Stable	Higher
Bank 20	Nordics	Higher	Higher
Bank 21	Poland	Lower	Lower

Source: EY analysis Q4-22.

Where retail borrowers are falling behind with repayments or struggling with higher costs of living, we see banks widening their forbearance approach. Some lenders are switching borrowers between products, by allowing temporarily reductions in monthly repayments or extending mortgage terms to adjust monthly costs.

Even so, we are starting to detect concerns over consumer credit deterioration, suggesting that this time pain might be felt in this group before the corporate segment. Levels of leverage are typically seen as the key driver of asset quality, rather than specific problems with certain sectors or client groups.

Exhibit 3 - EU Declarations of bankruptcies trend
EU (available countries), declarations of bankruptcies by activity*, Q1-15 to Q4-22



Source: Eurostat 3Q22.

Bankruptcies across Europe increased steeply in Q3-22 and accelerated further in Q4-22, with accommodation and food services, professional and support services, and construction leading the way. Transportation and storage bankruptcies declined in Q3 but rose again sharply in Q4. Businesses are struggling with rising costs, and overall bankruptcy levels exceeded those seen during COVID-19 pandemic's peak economic impact for the first time.

In the UK, the Insolvency Service reported 1,964 insolvencies in December 2022, 32% higher than December 2021 and 76% more than in pre-pandemic December 2019. These record numbers were driven by both voluntary and compulsory liquidations. Corporate insolvencies remained low during the pandemic due to government support but are now being pushed up by soaring energy costs and increasing interest rates.

October 2022 saw Spain's Act 16/2022 enter force, completely overhauling the Spanish insolvency system. The reform gives a more prominent role to creditors, who will benefit from pre-insolvency instruments, and introduces significant changes to insolvency proceedings. It completes the procedure for the ICO (Spanish State Finance Agency)-backed debt refinancing. The long-term effect of the Act remains to be seen, but business bankruptcy declarations in Spain jumped by 66% QoQ in Q3-22.

Exhibit 4 - Loan composition by stages Q3-22: Stage 2 loans increased Year-on-Year, indicating higher expected NPLs

Country	Stage 1	QoQ change	YoY change	Stage 2	QoQ change	YoY change	Stage 3	QoQ change	YoY change
EU/EEA	**88.3%**	**+0.0%**	**-0.4%**	**9.5%**	**+0.0%**	**+0.8%**	**2.1%**	**-0.1%**	**-0.5%**
France	87.5%	+0.1%	-1.5%	10.3%	-0.0%	+1.7%	2.2%	-0.1%	-0.3%
Spain	90.3%	+0.1%	+0.9%	6.6%	-0.0%	-0.6%	3.0%	-0.0%	-0.3%
Italy	83.7%	+0.6%	+0.7%	13.1%	-0.5%	+0.5%	3.0%	-0.0%	-1.4%
Germany	88.3%	+0.5%	-2.2%	10.4%	-0.4%	2.3%	1.3%	-0.0%	-0.2%
Netherlands	91.0%	-0.6%	-0.4%	7.4%	+0.6%	+0.7%	1.6%	-0.1%	-0.4%
Greece	80.2%	+0.8%	+6.0%	12.2%	-0.5%	-1.1%	6.2%	-0.3%	-6.4%
Portugal	86.7%	+2.9%	+3.6%	9.9%	-2.0%	-2.4%	3.2%	-0.8%	-1.4%
Ireland	85.0%	-0.1%	+4.8%	11.6%	+0.6%	-3.8%	3.3%	-0.6%	-1.1%
Poland	83.7%	+0.4%	+0.7%	11.8%	-0.3%	-0.4%	4.1%	-0.1%	-0.6%
Cyprus	78.5%	+1.9%	+6.1%	14.1%	-1.5%	-2.5%	4.8%	-0.3%	-6.2%

Stage 1
S1 > 85%
S1 <75%
S1 between 75%-85%

Stage 2
S2 > 15%
S2 <10%
S2 between 10%-15%

Stage 3
S3 > 7%
S3 < 3.5%
S3 between 3.5-7.0%

Source: European Banking Authority Q2 22, NPL markets

4. NPL stocks continue to fall, but market trends indicate a future increase in NPL volumes

Across Europe the total stock of NPLs in Q3-22 was c.€367.4bn, roughly 1% lower than the prior quarter and 12.4% lower year-on-year. France remains the largest contributor with NPLs of €109.6bn, followed by Spain (€79bn) and Italy (€51.2bn). Together these three markets account for c.65% of Europe's NPL stock.

The European NPL ratio was c.1.8% in Q3-22, stable from Q2-22. Noteworthy national NPL ratios include Greece (4.9%), Poland (4.2%), Cyprus (3.2%) and Portugal (3.1%), although it should be noted that NPL ratios for all the major European nations covered in this report have fallen YoY.

Europe's active NPL secondary markets continue to a key driver of falling NPL levels, with buyers' capital availability enabling significant portfolio transactions to take place. In addition to this, jurisdictions like Greece and Italy benefit from government-backed securitization schemes, with volumes accounting for c. €40b in 2021 and €14b in H1-22 - equivalent to c.40% and c.28% of total NPL transaction volumes respectively. These schemes help to bridge pricing gaps between originators and purchasers, which have historically been a hurdle to completing transactions.

Another driver of falling NPLs, mentioned in section 3 above, is the continuation of government support and stimulus packages. These factors, together with the stock of NPLs left over from the last financial crisis, mean that we expect proactive management to remain at the center of European banks' NPL strategies.

Market dislocation has led a number of portfolio transactions to be put on hold until 2023, with pricing impacted by widening bid-ask spreads. Despite this uncertainty portfolio deal levels have remained high. Other sellers continue to come to market, capitalizing on current prices given the potential for macroeconomic deterioration to trigger lower valuations.

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Italian banks' NPE stock continues to drop, reaching €67 b as of September 2022, with a 3.5% gross NPE ratio. Stage 2 stock continued to increase (up 73% since 2019) and equal to € 263 b. In this context, we expect that banks and Italian servicers will increase their specialization in the management of alternative asset classes such as stage 2 and unlikely to pay (UTP) loans, focusing on going-concern approaches and developing tailor made solutions to sustain business continuity.
In terms of transactions, the pipeline for primary deals out of banks remain quite low while the secondary market will continue to be increasingly relevant. In the period 2023- 2024, NPE inflows estimates are in a range between €40 – 70 b, with the consumer sector and SMEs most likely to feel the pinch of inflationary environment and monetary policies.

Luca Cosentino, Partner, EY Advisory S.p.A.

Exhibit 5 - NPL ratio heatmap Q3-22: Risk is concentrated in key markets and asset types

Asset Type	EU/EEA	France	Spain	Italy	Germany	Netherlands	Greece	Portugal	Ireland	Poland	Cyprus
NPL ratio	1.8%	1.8%	2.7%	2.6%	1.0%	1.2%	4.9%	3.1%	2.0%	4.2%	3.2%
-Households	2.2%	2.1%	3.6%	2.7%	1.4%	1.0%	9.6%	2.2%	2.8%	4.2%	9.3%
--Mortgages	1.5%	2.1%	2.6%	1.8%	0.7%	0.7%	8.6%	1.2%	2.3%	2.2%	9.0%
-NFC	3.3%	3.3%	4.1%	4.4%	2.3%	3.0%	7.2%	7.7%	5.2%	5.8%	4.0%
--SME	4.4%	4.0%	6.7%	6.2%	2.7%	3.4%	11.9%	8.4%	8.1%	7.7%	4.3%
--CRE	4.1%	2.9%	8.4%	8.9%	2.4%	2.8%	13.5%	12.6%	10.4%	9.1%	3.9%

NPL ratio
NPL ratio >15% NPL ratio < 5% NPL ratio between 5% and 15%

Source: EBA 3Q22 National Finance Corporation (NFC)* Commercial real estate (CRE)*

At an aggregated European level, SME and commercial real estate loans continue to have the highest NPL ratios, at 4.4% and 4.1%, respectively. Collectively, loans to non-financial companies have higher NPL ratios than loans to households (3.3% compared with 2.2%).

A look at different sectors of the economy shows that most sectors' overall NPL ratios either fell or stayed the same between Q2-22 and Q3-22.

Sectors with relatively high NPL ratios, as before, are accommodation and food service activities (8.4%), arts, entertainment and recreation (6.9%), construction (6.7%) and mining and quarrying (5.4%). All the other sectors covered by the European Central Bank reported average NPL ratios of less than 5%.

Conclusion

Key market trends at this sensitive moment are:

1. Europe's Stage 2 classified loans are continuing to grow, indicating potential future NPL volumes.
2. The latest market communications suggest that European banks' asset quality sentiment is slowly declining, and we expect continued pressure in future quarters.
3. Government support and moratoria continue to delay NPE creation, but most are expected to end in FY22.
4. Looking ahead, we expect to see NPE volumes increase as geopolitical events affect the market, especially in the energy and consumer sectors. Banks' ability to identify and respond to these macro trends remains critical.

Spotlight – Poland

Polish NPL market:

The Polish economy is expected to have grown c. 5.2% in 2022 despite significant headwinds but is expected to see a growth rate of just 0.4% in 2023 due to persistent inflation rates of over 10%. Poland's aggregate NPL ratio of 4.2% in Q3-22 was the second highest amongst the markets covered by the Tracker, although this was 0.8% percentage points lower than in Q3-21. Key advances in Poland include the government's Act on Assistance to Borrowers. This allows mortgage holders to postpone repayments for a total of 8 months and also extends the operation of anti-inflation shields by using a number of VAT cuts to combat rising inflation.

The Polish NPE market historically stands out among European Economic Area (EEA) jurisdictions in terms of volumes, but deal ticket sizes are relatively small. This has presented good opportunities for domestic lenders with relatively small secured and unsecured portfolios, but also constitutes a limit in terms of growth.

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In the short-term we do envisage some interesting pipeline of loan portfolio sales transactions as Polish financial institutions are currently planning to bring to market a number of sizable, secured loan books which could attract the interest of international investors with capacity to underwrite mid to upper mid-market size loan portfolio tickets. We also expect opportunities in the unsecured space strictly connected to the underlying performance of the economy and the local labor market. The current level of NPLs is still relatively low, with bank's general positive sentiment, however in the very first months of 2023 we started to observe significantly larger new defaults in retail portfolios compared to pre-COVID-19 market. It will be important to monitor this evolution closely, as well as any further new government stimulus and support to borrowers.

Lukasz Sikora, Partner, Ernst & Young Polska

NPE tracker methodology

The NPE tracker's main source of data is the EBA risk dashboard which summarizes the main risks and vulnerabilities in the banking sector in the European Union (EU) by looking at the evolution of risk indicators (RIs) among a sample of banks across the EU.

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.

In addition, to follow the pandemic's impact 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.

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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