

Non-performing exposures tracker Q4 2021

Shining a light on European lending

How will economic and monetary uncertainty impact European banks' asset quality? Are we about to experience a new phase for Europe's secondary non-performing exposure (NPE) markets?

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: Most major markets are relatively stable

Country	Loan volumes		Loan distribution among stages – Stage 2 vs. Stage 3 (IFRS9)		NPL stock (€b)		NPL ratio (%)			Loans with public guarantee	
	Total loans Q4-21 (€b)	Total new loans YoY (%)	Stage 2: Q4-21 vs Q4-20 (%)	Stage 3: Q4-21 vs Q4-20 (%)	NPL stock Q4-21 (€b)	NPL stock YoY Q4-21 (%)	Historical max (%)	Q4-21 (%)	Q4-21 vs. Q4-20 absolute change (%)	Amount Q4-21 (€b)	% of total loans
France	5,831	7.2%	0.6%	-0.2%	110.9	-7.0%	3.0%	1.9%	-0.3%	110.0	1.9%
Spain	2,706	13.6%	0.3%	-0.1%	82.4	18.3%	4.5%	3.0%	0.1%	103.6	3.8%
Italy	1,970	6.2%	0.2%	-1.4%	60.8	-20.7%	10.8%	3.1%	-1.0%	120.5	6.1%
Germany	2,707	5.9%	-0.6%	-0.2%	29.7	-8.8%	1.7%	1.1%	-0.2%	12.0	0.4%
Netherlands	1,918	3.6%	-1.7%	-0.5%	28.9	-21.5%	2.3%	1.5%	-0.5%	3.2	0.2%
Greece	216	2.7%	-0.4%	-21.6%	15.2	-71.7%	45.3%	7.0%	-18.5%	5.5	2.5%
Portugal	220	-11.9%	1.2%	-1.4%	7.7	-36.7%	13.6%	3.5%	-1.4%	7.6	3.5%
Ireland	271	21.7%	-3.5%	-1.1%	7.7	-17.4%	8.2%	2.8%	-1.3%	1.0	0.4%
Poland	129	8.1%	-0.8%	-0.9%	5.8	-4.0%	6.8%	4.5%	-0.6%	3.7	2.8%
Cyprus	33	21.1%	-1.8%	-11.2%	1.4	-56.5%	38.9%	4.1%	-7.4%	0.0	0.0%
EU/EEA	19,190	5.6%	-0.2%	-0.7%	391.3	-16.3%	3.8%	2.0%	-0.5%	372.8	1.9%

Non-performing loans (NPLs) outlook and risk level

Negative: high
 Watchlist: medium
 Stable: low

Source: European Banking Authority Q4 2021, NPL markets

This edition of the tracker focuses on five key findings:

1. Macroeconomic deterioration is not in the numbers – yet

European economies face major new challenges, most notably i) the onset of inflation, ii) commodity and energy price shocks, and iii) geo-political risks. This means that the withdrawal of post-COVID-19 government stimulus and moratoria is taking place at an exceptionally delicate juncture.

The prospects for economic recovery in 2022 are darkening, and many experts doubt whether the global economy and Europe's in particular, is robust enough to prevent the energy crisis from sparking recession and inflation. The question now is how these economic challenges will impact banks' asset quality in the coming quarters.

2. Europe's Stage 2 classified loans are growing again, indicating potential future NPL volumes

Data on international financial reporting standards (IFRS) loan categories shows that European banks' ratio of Stage 2 loans (those performing but with increased risk) grew from 8.7% in Q3-21 to 8.9% in Q4-21. This marks a change in the decreasing trend we saw throughout 2021, following the peak of 9.1% reached in Q4-20. The key European markets driving the QoQ increase in the Stage 2 provisioning ratio are Italy (+1.5%), Portugal (+1.1%), Germany (+0.6%) and France (+0.5%). Conversely, Ireland saw a 3.3% decrease in Stage 2 classified loans.

Stage 2 loans may now represent 8.9% of the overall European loan book, but the ratio of Stage 3 loans (those that are non-performing) has decreased by c.0.2% QoQ (and fallen by 0.7% YoY), as shown in exhibit 4 below.

The increase in the relative and total level of European Stage 2 provisioning also occurs against a backdrop of an overall decline in the stock of NPLs. YoY comparators show an average decrease of 16.3% across Europe. Coupled with this, the origination of new business continues to grow, with a 5.6% overall increase in new loans across Europe for the year to date when compared with the prior year.

This combination of falling NPL levels and higher deal origination implies an overall increase in underlying asset quality. However, a delay in NPL formation due to government support and stimulus programs could also be a factor. We consider the impact of government support in greater detail below.

3. European banks' asset quality sentiment remains positive, based on the latest market communications, but we expect fresh pressure in future quarters

In line with our previous report, EY teams have conducted an exercise to review European banks' earnings calls' transcripts for Q4-21 (see methodology for details) to better understand views on credit markets and NPE volumes. Banks' reporting dates and the preparation of this report occurred before the war in Ukraine. Therefore, they do not reflect the impact of this event.

The overall message from our research suggests that while some banks across Europe are starting to expect an inflow of NPLs, not all are anticipating a large influx of COVID-19-related NPLs in the short term – as evidenced by the EEA NPL ratio, which remains low at 2.0%. See Exhibit 1 for further details. More specifically:

- ▶ Based on the data collected, it appears that Spanish banks have the greatest expectation of seeing an increase in NPLs in the short term, with one quoting a forecasted 32% increase in volumes. It seems that this sentiment is shared by a number of other banks across Europe, with one bank in the UK and one in France forecasting increases of 13% and 23%, respectively. According to a survey conducted by the Bank of England during February and March 2022, British lenders expect a rise in mortgage NPLs amid growing costs of living. In the same vein, the Bank of Spain warned in early April of an increase in delinquencies due to the deterioration of macroeconomic conditions.
- ▶ However, the majority of banks included in our exercise continue to forecast either a stable or lower level of NPLs in the immediate future. This appears to indicate that while NPL volumes are still expected to increase, the extension of government support into H1 2022 is limiting Covid-19-driven NPL volumes for originators. The impact of government support is discussed further below.
- ▶ Similar trends are evident when it comes to cost of risk. All but one of the banks covered by our exercise continue to forecast their average cost of risk to decrease.
- ▶ In addition, the **EY European Bank Lending Forecast** predicts that loan losses across the eurozone will rise, growing by 3.4% in 2022 and a further 3.9% in 2023, from an average of 2.4% over 2020 and 2021. However, defaults are set to remain modest by historical standards: losses averaged 6% from 2012 to 2019 and reached 8.4% in 2013 in the aftermath of the eurozone debt crisis. Immediately pre-pandemic, loan losses averaged 3.5% across 2018 to 2019.

Exhibit 2 – European banks' NPE outlook continues to be positive (reporting season Q4-21)

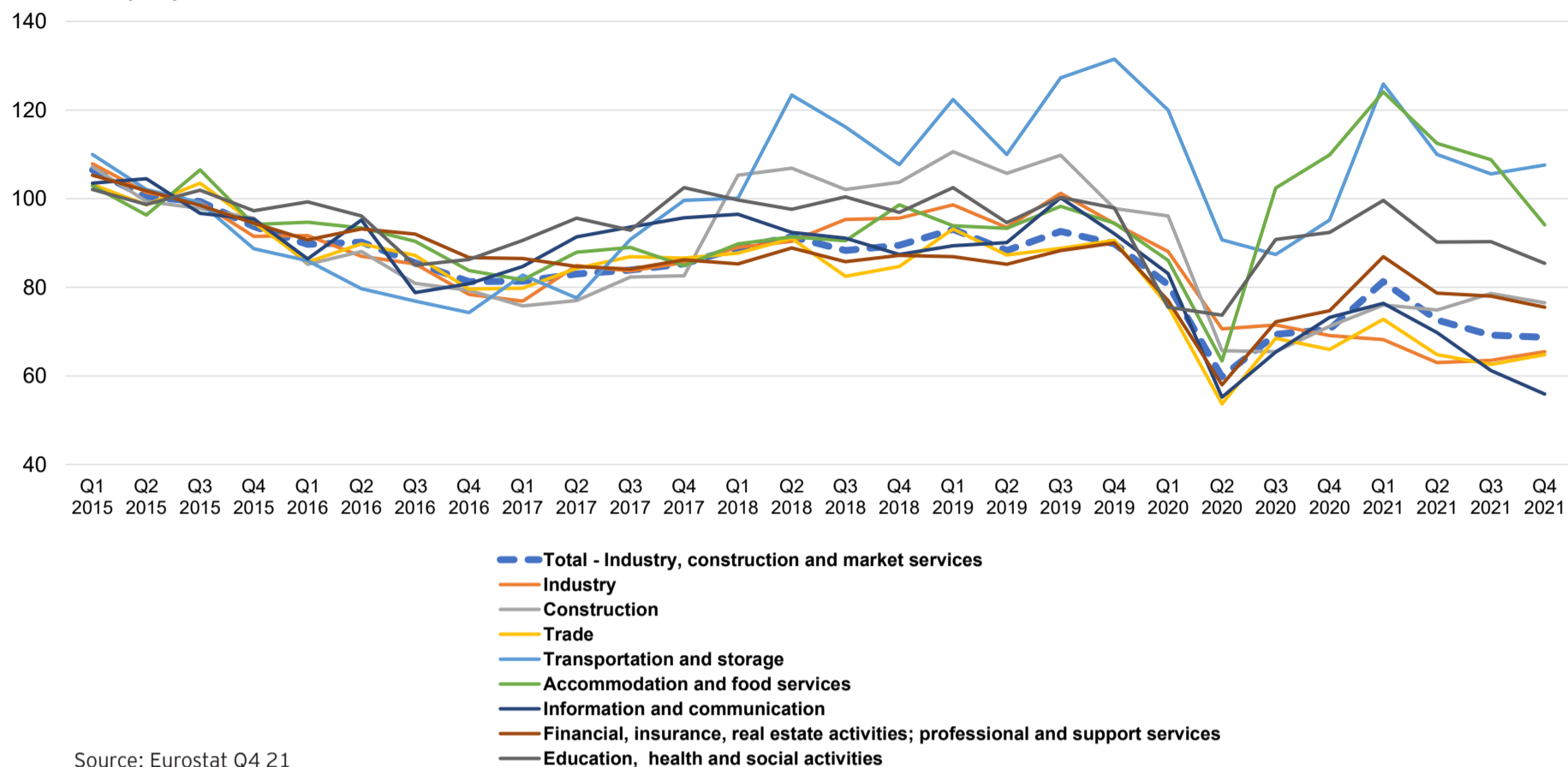
Bank	Country	NPL expected Inflows	Cost of risk
Bank 1	Spain	Higher	Higher
Bank 2	Spain	Higher	Lower
Bank 3	Spain	Higher	Lower
Bank 4	UK	Stable	Lower
Bank 5	UK	Lower	Lower
Bank 6	UK	Higher	Lower
Bank 7	Italy	Stable	Lower
Bank 8	Italy	Lower	Lower
Bank 9	Italy	Lower	Lower
Bank 10	France	Lower	Lower
Bank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

Exhibit 3 – European bankruptcy rates continue to increase in some sectors

EU (available countries) Declarations of bankruptcies of businesses by activity*, Q1 2015 to Q4 2021

(2015=100)

*Seasonally adjusted



Source: Eurostat Q4 21

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

As demonstrated in Exhibit 3 above, however, the key question now is how different sectors of the economy will respond to evolving circumstances and the withdrawal of government assistance, particularly in industries like hospitality and leisure.

Commercial bankruptcies are a potential indicator of overall market conditions. These trended down in the years before the pandemic and fell steeply in Q2-20 as moratoria and guarantees were put in place by European governments. Business failures have increased in the post-COVID-19 market,

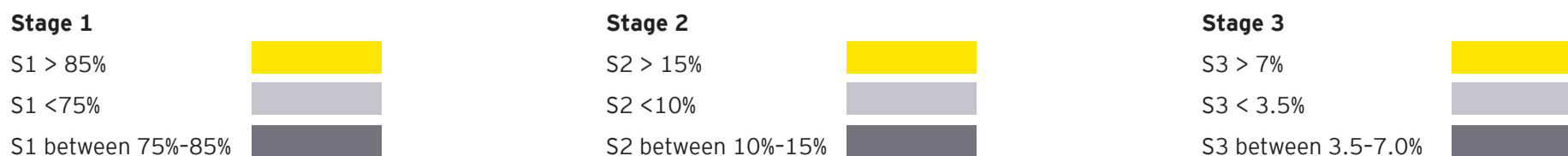
with bankruptcies up in almost all sectors during the first half of 2021 (especially in accommodation and food, transport and storage, and social activities).

Looking at 2021 as a whole, it's true that bankruptcies decreased in accommodation and food services, information and communication, and financial and insurance services. But the number of bankruptcy declarations increased in transport, trade, and industry from Q3-21 to Q4-21.

Coupled with this, the instability of the macro geopolitical environment is generating uncertainty both for businesses (particularly those with a global footprint) and for government policy. European banks' ability to respond to this and manage their exposures will be key.

Exhibit 4 - Loan composition by stages Q4-21: Stage 2 loans are trending upwards, indicating potential future NPLs

Country	Stage 1	QoQ growth	YoY growth	Stage 2	QoQ growth	YoY growth	Stage 3	QoQ growth	YoY growth
Cyprus	77.2%	4.8%	13.0%	16.6%	0.0%	-1.8%	6.1%	-4.9%	-11.2%
Germany	90.0%	-0.5%	0.8%	8.6%	0.6%	-0.6%	1.4%	-0.0%	-0.2%
Spain	89.4%	-0.1%	-0.1%	7.4%	0.1%	0.3%	3.3%	-0.0%	-0.1%
France	88.6%	-0.4%	-0.4%	9.0%	0.5%	0.6%	2.4%	-0.1%	-0.2%
Greece	78.0%	3.8%	22.0%	13.3%	0.1%	-0.4%	8.7%	-3.9%	-21.6%
Ireland	83.6%	3.4%	4.6%	12.1%	-3.3%	-3.5%	4.3%	-0.1%	-1.1%
Italy	82.3%	-0.8%	1.2%	14.0%	1.5%	0.2%	3.7%	-0.7%	-1.4%
Netherlands	92.2%	0.8%	2.3%	6.0%	-0.7%	-1.7%	1.8%	-0.1%	-0.5%
Poland	83.6%	0.6%	1.6%	12.2%	-0.1%	-0.8%	4.3%	-0.5%	-0.9%
Portugal	82.3%	-0.8%	0.1%	13.4%	1.1%	1.2%	4.3%	-0.4%	-1.4%
EU/EEA	88.6%	-0.1%	0.9%	8.9%	0.3%	-0.2%	2.4%	-0.2%	-0.7%



Source: European Banking Authority Q4 2021, NPL markets

4. Government support and moratoria continue to delay NPE creation across European banks

As detailed in our previous reports, the COVID-19 pandemic prompted most European countries to create some form of loan moratorium or public guarantee scheme to support businesses. A number of these government schemes have been extended into 1H-2022. Therefore, we expect some of the impact caused by COVID-19-era NPLs to be felt during the course of this year.

Evidence of the unwinding of government support comes from the YTD loans under moratoria figures, which have decreased significantly to c.€12b (compared with €50b in Q3-21), representing just c.0.1% of current total loans. Conversely, however, loans with a public guarantee have remained relatively flat at €372b (1.9% of the market). A key issue for public guaranteed balances is the differing definitions and criteria set by local governments. It is therefore expected that as government support falls away, elements of these balances may generate future NPL volumes for European banks.

5. NPL stocks continue to fall, but market trends indicate a future increase in NPL volumes which will need to be resolved

Across Europe, the total stock of NPLs in Q4-21 was c.€391b. This represents a 6.6% decrease QoQ, and a 17.8% YoY fall. France is now the

largest contributor to the region's NPLs (€110.9b), followed by Spain (€82.4b) and Italy (€60.8b), which collectively account for c.65% of the NPL stock by value.

The European NPL ratio was c.2.0% in Q4-21, a 0.1% decrease from Q3-21. Noteworthy countries' NPL ratios include Greece (7.0%); Cyprus (4.1%); Portugal (3.5%) and Italy (3.1%). It should be noted though that the NPL ratio decreased across all the major European nations covered in this report.

A key driver impacting the decrease in NPL levels continues to be Europe's active NPL sales markets, with the availability of capital for purchasers enabling significant portfolio transactions to take place. In addition to this, jurisdictions such as Greece and Italy also benefit from government-backed securitization schemes. These are aiding sales by bridging the pricing gap between originators and purchasers, which had historically been a hurdle to completing transactions.

A second driver, as mentioned in Section 3 above, is the continuation of government support and stimulus packages. Coupled with the historical stock of NPLs left over from the last financial crisis, we anticipate that a proactive NPL management approach will continue to remain at the center of European banks' NPL strategies.



Borrowers within the UK are facing an unprecedented squeeze on their incomes. Several interdependent factors, including an increase in the cost of living, higher national insurance contributions, energy costs, interest rates and fuel prices, have resulted in a perfect storm for borrowers – many of whom are still dealing with the impact of the pandemic. With inflation rates running at a 30-year high of change combined with the unwinding of COVID-19 relief measures – and in many cases, a return to the repayment of said relief measures – never before have customers felt the pinch across so many different elements of their income and expenditure. One thing is certain – while this will likely result in significant distress across all asset classes, it is only a matter of time before banks begin to explore how they could look to offload these portfolios. However, the key question to answer is whether they will seek to outsource collections to specialist local services, or whether they'd prefer to recognize these NPLs via large scale portfolio disposals as we saw in the post global financial crisis era.

Hardip Bhatti, Associate Partner, Ernst & Young LLP



Italian banks' NPE stock dropped to €79b in 2021, with a 4.1% gross NPE ratio widely below the European Banking Authority threshold. NPE transactions reached c.€31b in 2021, of which 32% was represented by secondary market transactions and with an incidence of GACS* deals equal to 36%. In 2022 through 2024, new inflows of NPEs are expected as a consequence of the COVID-19 pandemic, while the potential impact generated by the war in Ukraine remains uncertain. We expect the Italian NPE transaction market will remain dynamic in the coming years, and in such a context we expect that secondary market and UTP** deals will continue to increase. Furthermore, we expect Italian servicing players will increase their specialization in the management of Stage 2 loans and public-guarantee scheme loans. At the same time, investors could expand their interest to alternative asset classes such as public administration credit and infrastructure technical reserves.

*GACS: Garanzia Cartolarizzazione Sofferenze

**UTP: Unlisted trading privileges

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

Asset Type	Cyprus	Germany	Spain	France	Greece	Ireland	Italy	Netherland	Poland	Portugal	EU/EEA
NPL ratio	4.1%	1.1%	3.0%	1.9%	7.0%	2.8%	3.1%	1.5%	4.5%	3.5%	2.0%
- Households	11.3%	1.5%	3.8%	2.3%	10.5%	4.0%	3.3%	1.2%	3.8%	2.5%	2.4%
- Mortgages	11.3%	0.8%	3.1%	2.1%	8.9%	3.7%	2.5%	0.9%	2.1%	1.5%	1.8%
NFC	4.7%	2.3%	4.8%	3.5%	11.9%	6.3%	5.4%	3.4%	6.4%	8.3%	3.8%
- SME	4.7%	2.7%	7.2%	4.0%	18.7%	10.5%	7.6%	4.0%	7.7%	8.1%	5.0%
- CRE	4.5%	2.3%	9.7%	3.3%	21.6%	12.0%	10.7%	3.6%	10.3%	12.0%	4.9%

NPL ratio

NPL ratio >15%

NPL ratio <5%

NPL ratio 5-15%



At an aggregated European level, commercial real estate and small and medium-sized enterprise (SME) loans continue to have the highest NPL ratios, at 5.0% and 4.9%, respectively. Collectively, all non-financial loans still have higher NPL ratios than loans to households (3.8% compared with 2.4%).

When considering different sectors of the economy, each sector's overall NPL ratio remained flat or decreased between Q3-21 and Q4-21. Notable market sectors from an NPL ratio perspective continue to be accommodation and food service activities (9.4%), construction (8.0%), arts, entertainment and recreation (7.8%) and mining and quarrying (5.6%). All other sectors covered by the European Central Bank had a reported NPL ratio of less than 5%.

Conclusion

NPL levels continue to remain manageable for European banks, helped by portfolio sales and continuing government support measures. However, economic and geopolitical uncertainties are overshadowing the outlook for asset quality.

Key market trends at this sensitive moment are:

1. Europe's Stage 2 classified loans are growing again, indicating potential future NPL volumes.
2. European banks' asset quality sentiment remains positive, based on the latest market communications, but we expect fresh pressure in future quarters.

3. Government support and moratoria continue to delay NPE creation across European Banks.
4. NPL stocks continue to fall, but market trends indicate a coming increase in NPL volumes which will need to be resolved.
5. Looking ahead, we expect to see NPE volumes increase as wider geopolitical events unfold, especially in some key sectors of the economy. Banks' ability to identify these macro trends and respond accordingly will be critical.

NPE tracker methodology

1. 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.
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 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.

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

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- ▶ We have a strong internal network, breadth of knowledge and vast array of credentials covering different macroeconomic landscapes.



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