Non-performing exposures tracker, Q4 2022

Shining a light on European lending

Building a better working world

How are banks safeguarding asset quality during times of higher inflation and interest rates?

The EY Non-performing exposure (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 Non-performing loan (NPL) heatmap summary: NPL stocks continue to decrease but Stage 2 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 Q4-22 (€b)[1]	Q4-22 (%)	Stage 2: Q4-22 vs Q4-21 (%)	NPL stock Q4-22 (€b)	NPL stock YoY Q4-22 (%)	5 Year Historical max (%)[2]	Q4-22 (%)	Q4-22 vs. Q4-21 abs change (%)	Amount (€b)	% of total loans
EU/EEA	**19,836**	**+3.4%**	**1,866**	**9.4%**	**+0.5%**	**357**	**-8.7%**	**3.8%**	**+1.8%**	**-0.2%**	**328**	**1.7%**
France	6,008	+3.0%	590	9.8%	+0.8%	111	+0.5%	3.0%	+1.9%	-0.0%	93	1.5%
Spain	2,725	+0.7%	186	6.8%	-0.6%	76	-8.4%	4.5%	+2.8%	-0.3%	88	3.2%
Italy	1,873	-5.0%	228	12.2%	-1.9%	46	-24.9%	10.8%	+2.4%	-0.6%	114	6.1%
Germany	2,871	+6.0%	283	9.9%	+1.2%	32	+6.4%	1.7%	+1.1%	+0.0%	10	0.3%
Netherlands	1,927	+0.4%	153	7.9%	+1.9%	27	-7.0%	2.3%	+1.4%	-0.1%	3	0.2%
Greece	215	-0.3%	24	11.4%	-2.0%	10	-35.1%	45.3%	+4.6%	-2.5%	4	2.0%
Portugal	220	-0.0%	25	11.5%	-1.9%	7	-15.4%	13.6%	+3.0%	-0.5%	7	3.1%
Ireland	292	+7.8%	37	12.6%	+0.4%	5	-32.3%	8.2%	+1.8%	-1.1%	1	0.3%
Poland	137	+5.7%	14	10.4%	-1.8%	6	-0.0%	6.8%	+4.2%	-0.2%	4	3.3%
Cyprus	35	+6.3%	5	13.1%	-3.5%	1	-20.7%	38.9%	+3.1%	-1.0%	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
Watch list: medium
Stable: low

Source: EBA Q4-22

This edition of the tracker focuses on four key findings:

1. Navigating macroeconomic challenges: weak growth and an uncertain outlook could affect NPLs

The economic outlook has shown signs of improvement since the previous *EY bank lending report in autumn 2022*. The eurozone economy has exceeded expectations, supported by varied factors including a mild winter, lower energy prices, China's re-opening and fiscal support. However, projected growth in both GDP and bank lending is expected to be sluggish in the coming years. On the upside, consumer spending is anticipated to receive a boost from low unemployment rates, rising wages, and a forecasted decline in inflation - although it remains entrenched. In addition, the industry sector will benefit from more affordable energy and more stable supply chains. Nevertheless, overall growth will be restrained by higher interest rates, tighter credit conditions, and weaknesses in the global economy. The forecast for eurozone GDP indicates an increase of 0.8% this year and 1% in 2024, a significant shift from the previous forecasts of -0.1% and +1.7% respectively.

Bank lending growth in the eurozone has recently slowed, reaching a five-quarter low. While lending to households and businesses is expected to experience modest growth in the next few years, factors such as rising interest rates and declining inflation, makes it difficult to predict whether lending will expand in the near future.

Despite potential risks, eurozone banks have demonstrated resilience, boasting strong capital and liquidity positions. However, NPLs are projected to increase owing to rising interest rates, with Spain and Italy considered the most vulnerable markets. Set against that, historically low levels of NPLs, healthy household savings, low unemployment rates and improved energy prices should offer some protection against the effects of higher interest payments.

2. Continued increase in Stage 2 classified loans across Europe

Data on international financial reporting standards (IFRS) loan categories shows that European banks' Stage 2 loans (those performing but with increased risk) amount to €1,866.2b or 9.4% of total loans in Q4-22 (see Exhibit 1 above). This is slightly lower than the previous quarter, but it represents a year-on-year (YoY) increase of 0.5 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. Portugal (+1.6%), Ireland (+1.0%), the Netherlands (+0.5%) and Spain (+0.2%) experienced growth; while Poland (-1.4%), Cyprus (-1.0%), Italy (-0.9%), Greece (-0.8%), France (-0.5%) and Germany (-0.5%) all saw falls in Stage 2 ratios.

In contrast to Europe's Stage 2 loans, the region's overall stock of NPLs is falling, with YoY comparators showing an aggregate decrease of 8.7% in NPL stocks across Europe. The ratio of stage 3 loans (those that are non-performing) remained flat QoQ and fell by 0.3% YoY, as shown in Exhibit 4 below.

While some of the growth in Stage 2 loans may be driven by accounting classification triggers, the YoY growth in Stage 2 loans implies a need for banks to sharpen their loan portfolio management. It also points to increasing potential for market-oriented actions such as securitization – especially if the macroeconomic landscape continues to deteriorate.

3. European banks' asset quality sentiment remains stable, based on the latest market communications – but with some exceptions and variations

- In line with our previous reports, EY teams have reviewed European banks' earnings call transcripts for Q1-23 (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 future direction of NPL inflows, although many have witnessed a fall in costs of risk and expect a stable picture in the near future. Separate EY research also predicts higher loan losses in the years ahead, due to the increases seen in Stage 2 assets. More specifically:
- Most European banks appear to be experiencing a quarterly decrease in cost of risk, with the exception of a few British, Spanish and Polish banks. This is largely attributable to macroeconomic forecasts. These remain benign and in some cases are now more positive than previously forecasted in 2022.
- Banks across mainland Europe largely expect resilience in customer repayments. The UK banks are an exception here, with the effect of high inflation on customer arrears yet to become apparent.
- After enjoying a long period of low interest rates, banks expect the rise in rates across Europe to have a negative impact on margins and net interest income. As rates approach their peak and the economy weakens, there is an expectation of higher loan losses. A weaker economy and higher borrowing costs are predicted to drive increased impairments across various types of lending. Stricter credit standards and lower loan demand will further intensify competition, putting pressure on margins.
- Apart from a handful of institutions, most European banks expect a stable NPL outlook due to elevated but not excessive expectations for default risk. Cautious provisioning during 2022, together with a less negative economic outlook than previously predicted, is allowing banks to actively manage arrears and defaults as they arise. According to the recent credit conditions survey conducted by the Bank of England, UK lenders saw default rates increase in Q1-23 for secured and unsecured lending to businesses of all sizes, with an expectation of further increases in Q2-23.
- Focusing on UK mortgages, approvals fell by c.50% during 2022. Tighter regulations and lending criteria introduced after 2008 should mean that borrowers are better able to deal with higher rates than during previous cycles, while savings built up during the pandemic are likely to give households a cushion against falling incomes. Refinancing risk, however, remains high as customers feel pressure from high interest rates alongside inflationary effects.
- Germany's bank lending is expected to experience the weakest growth among major eurozone economies this year, owing to a cooling housing market and a relatively weak GDP outlook. The slowdown in the housing boom will have a particularly negative impact on mortgage lending growth.

Exhibit 2: European banks' NPL outlook is finely balanced, with downside risks (reporting season Q1-23)

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

Source: EY analysis Q1-23

Higher Stable Lower

Of the 21 sets of results that we reviewed, only 4 banks saw an increase in NPL levels. Of these, only one German bank raised alarms – increasing stage 3 provisions by €283 million between Q4-22 and Q1-23. Although forward-looking indicators pointed to an expected improvement in the macro-economic environment, the increase in interest rates is negatively affecting refinancing conditions for CRE loans. This, coupled with specific events in the bank's private banking division, resulted in higher credit provisioning.

Although most banks indicated a lower or stable cost of risk, five banks across the UK, Spain and Poland reported higher risks. This was partly expected, since the UK continues to face unprecedented levels of inflation. Spain however saw inflation fall to its lowest levels in two years (2.9%), suggesting that the increased cost of risk is a reflection of refinancing risk arising from higher funding costs.

In response to increased living costs and greater repayment difficulties for retail borrowers, banks are adopting a more flexible approach by implementing forbearance measures. These measures include transferring borrowers to different products, providing temporary reductions in monthly repayments, and extending mortgage terms to adjust affordability.

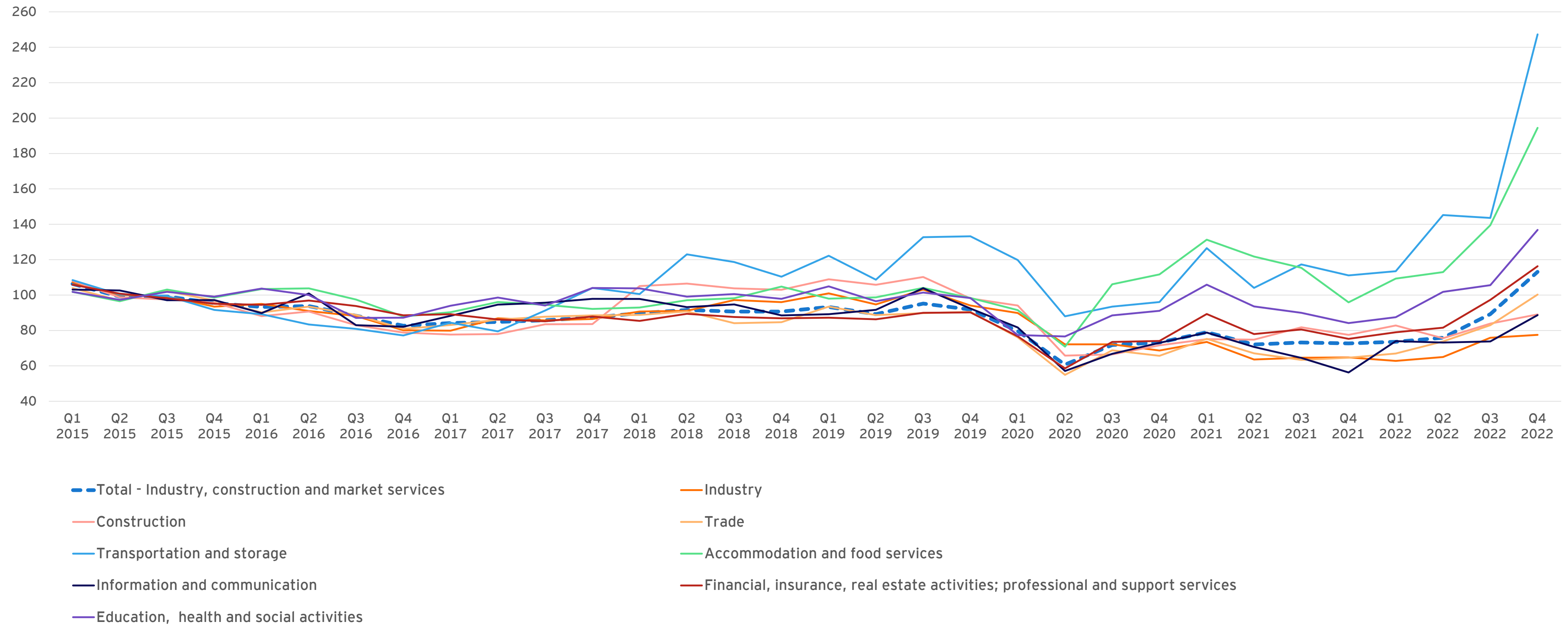
However, we are beginning to observe concerns regarding the deterioration of consumer credit, indicating that this segment may experience challenges before the corporate sector. Levels of leverage are typically considered the primary driver of asset quality, but specific issues affecting particular client segments are not a major contributing factor at present.

Regarding private sector lending, we anticipate a rise in the proportion of NPLs relative to overall lending. Our forecast suggests that this share will increase to 2.6% in the current year, up from 1.8% in 2022. Looking ahead, NPLs are expected to continue their upward trend, reaching 3.9% in 2024 as the impact of higher interest rates gradually crystallizes. It is important to note that these projected ratios remain significantly lower than those observed at the time of the eurozone debt crisis in 2013, when NPLs peaked at 8.4%*.

*Source:https://www.ey.com/en_gl/news/2023/06/eurozone-bank-lending-growth-forecast-to-fall-this-year-and-next-as-rising-interest-rates-drive-a-drop-in-loan-demand

Exhibit 3: EU declarations of bankruptcies trend

EU (available countries), declarations of bankruptcies by activity*, Q1-15 to Q4-22 (2015=100), *Seasonally adjusted



Source: Eurostat Q4-22

In Q1-23, bankruptcy declarations in the European Union (EU) increased by 2.8% compared to the previous quarter. This is the highest level since Q3-19, as business struggle with rising costs. Throughout 2022, bankruptcies exhibited a steady upward trend across all sectors, with the most notable increases affecting transportation and storage, accommodation and food services, and education, health and social activities. The first quarter of 2023 saw bankruptcies fall in transportation and storage, as well as in accommodation and food, as these sectors – heavily impacted by the pandemic – begin to rebound with the ongoing economic recovery. In contrast, industrial companies, the financial sector, information and communication companies and the education, health and social sector all experienced a slight uptick in bankruptcies in Q1-23.

Corporate insolvencies in the UK surged by 40% in the year leading up to May-23, driven by increasing costs and a sluggish economy. According to the Insolvency Service, there were 2,552 registered company insolvencies last month, a significant rise from 1,825 in May 2022 and nearly double the number recorded in May 2019. Businesses faced tough conditions and are grappling with high borrowing costs and elevated input prices, particularly on payroll, which put pressure on profit margins. Corporate insolvencies remained low during the pandemic due to government support, but are now being pushed up by higher energy costs and increasing interest rates.

In addition, according to the Bank of England's Credit Conditions Survey Q1-23, default rates rose across loan categories including secured loans to households, unsecured lending (including credit cards), and loans to small- and medium-sized businesses during the first quarter of 2023. These rates were projected to increase further in Q2-23. Default rates for large businesses remained unchanged. Losses given default (LGD) saw slight increases for medium and large businesses but remained unchanged for small firms; in contrast, LGDs were predicted to remain unchanged for small and large businesses in Q2-23, but to increase slightly for medium-sized firms.

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 69% QoQ in Q4-22.

Exhibit 4: Loan composition by stages Q4-22: 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%**	**0.1%**	**-0.3%**	**9.4%**	**-0.1%**	**0.5%**	**2.1%**	**0.0%**	**-0.3%**
France	87.8%	0.4%	-0.8%	9.8%	-0.5%	0.8%	2.3%	0.1%	-0.1%
Spain	90.2%	-0.1%	0.8%	6.8%	0.2%	-0.6%	2.9%	-0.1%	-0.3%
Italy	84.9%	1.1%	2.6%	12.2%	-0.9%	-1.9%	2.8%	-0.2%	-0.9%
Germany	88.7%	0.4%	-1.3%	9.9%	-0.5%	1.2%	1.3%	0.1%	0.0%
Netherlands	90.4%	-0.6%	-1.8%	7.9%	0.5%	1.9%	1.7%	0.1%	-0.2%
Greece	81.8%	1.6%	3.9%	11.4%	-0.8%	-2.0%	5.4%	-0.8%	-3.3%
Portugal	84.8%	-2.0%	2.4%	11.5%	1.6%	-1.9%	3.5%	0.3%	-0.8%
Ireland	84.6%	-0.5%	1.0%	12.6%	1.0%	0.4%	2.8%	-0.5%	-1.5%
Poland	85.2%	1.5%	1.6%	10.4%	-1.4%	-1.8%	4.1%	0.0%	-0.2%
Cyprus	79.4%	0.9%	2.2%	13.1%	-1.0%	-3.5%	4.9%	0.1%	-1.3%

Source: European Banking Authority Q4-22

Stage 1
Stage 1 > 85%
Stage 1 < 75%
Stage 1 between 75% and 85%

Stage 2
Stage 2 > 15%
Stage 2 < 10%
Stage 2 between 10% and 15%

Stage 3
Stage 3 > 7%
Stage 3 < 3.5%
Stage 3 between 3.5% and 7%

4. NPL stocks continue to fall, but market trends indicate a future increase in NPL volumes - Are we moving into a buyers' market?

Across Europe, the total stock of NPLs in Q4-22 was c.€357.4b, roughly 3% lower than in the prior quarter and 8.7% lower year-on-year. France remains the largest contributor with NPLs of €111.5b, followed by Spain (€75.5b) and Italy (€45.7b). Together these three markets account for c.65% of Europe's NPL stock.

Europe's active NPL secondary markets continue to be 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 of c.€40b in 2021 and €27b in 2022 - equivalent to c.40% and c.28% of total NPL transactions respectively. These schemes help to bridge pricing gaps between originators and purchasers, which have historically been a hurdle to completing transactions.

Current market conditions in European loan portfolio markets reveal important insights. Financial institutions, particularly non-bank lenders, face a trade-off between holding long-dated back book loans and pursuing higher margin products. The P&L impact of lower-rate back book portfolios may be limited by hedging structures and market liquidity, but institutions without safeguards face increased risks.

For institutions considering strategic deleveraging, effective portfolio selection is crucial to attracting investors and minimizing transaction failures. This is made particularly important by broadening bid-ask spreads, longer deal durations, reduced portfolio sales volumes, and the complex financing requirements of investors - which often involve structured solutions and deferred payments to sellers.

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Recently, members of our Loan Portfolio Solutions team (LPS) team attended the Global ABS conference in Barcelona where they engaged in discussions regarding the outlook for the portfolio market. While we are continuing to see a steady flow of performing portfolios off the back of rising funding rates and determination of non-core offerings, it is clear that market sentiment is leaning toward a likely surge of NPL portfolios given the unsteady macroeconomic outlook. The majority of conversations were centred around not whether or not this was likely – there was general consensus that this will indeed happen – but more the timing and quantum of such portfolios coming to market. Suffice to say, all market participants stand ready to take advantage of the opportunities as and when they present themselves.

Hardip Bhatti, Partner, Ernst & Young LLP

Exhibit 5: NPL ratio heatmap Q4-22: 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%	1.9%	2.8%	2.4%	1.1%	1.4%	4.6%	3.0%	1.8%	4.2%	3.1%
-Households	2.1%	2.1%	3.5%	2.3%	1.3%	1.0%	9.5%	2.1%	2.1%	4.2%	9.0%
--Mortgages	1.5%	2.1%	2.5%	1.6%	0.7%	0.8%	8.6%	1.1%	1.6%	2.2%	8.6%
-NFC	3.3%	3.4%	4.1%	4.1%	2.3%	3.1%	6.3%	7.1%	4.8%	5.7%	4.3%
--SME	4.3%	4.0%	6.7%	5.8%	2.4%	3.4%	10.7%	7.6%	6.9%	7.7%	4.7%
--CRE	3.7%	2.9%	8.3%	7.6%	2.1%	2.8%	11.8%	11.9%	7.2%	7.4%	4.2%

Source: EBA Q4-22. National Finance Corporation (NFC) Commercial real estate (CRE)

NPL ratio

NPL ratio >15%

NPL ratio < 5%

NPL ratio between 5% and 15%

At an aggregated European level, small and medium-sized enterprise (SME) and commercial real estate (CRE) loans continue to have the highest NPL ratios, at 4.3% and 3.7%, respectively. Collectively, loans to non-financial companies have higher NPL ratios than loans to households (3.3% compared with 2.1%).

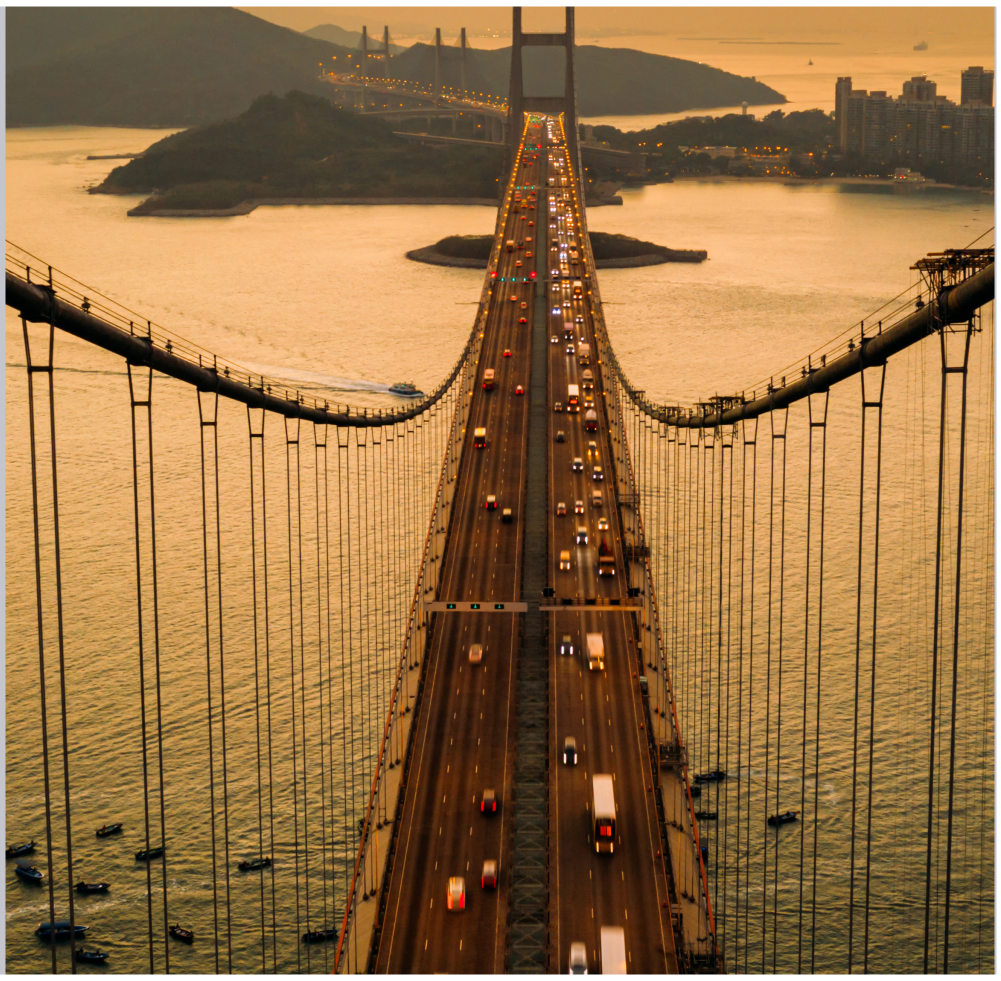
According to Bayes Business School, European banks hold less than 10% of their loans in CRE, with conservative loan-to-value ratios (LTVs) of 60-50%. However, increasing debt costs and refinancing challenges are impacting some assets. For example, in the UK, office vacancy rates are rising and commercial landlords faced a decline in rent collection during Q1-23. Rent collections were only 63% of amounts due, raising concerns for investors and putting property values at risk. Retailers were the main contributors to the decline in rent collection, while industrial property remained resilient.

A look at different sectors of the economy shows that most industries' overall NPL ratios remained largely similar, with changes of up to 0.5% in either direction between Q3-22 and Q4-22. The exception here was human health services and social work activities where NPLs increased to 4.9% from 2.2% at the end of Q3-22. Sectors with relatively high NPL ratios, as before, are accommodation and food service activities (7.9%), arts, entertainment and recreation (6.4%), construction (6.2%) and mining and quarrying (5.5%). 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. Challenges persist: The unclear direction of the economy, low provisioning levels, and future concerns on asset quality pose ongoing difficulties for banks.
2. Increase in Stage 2 classified loans: European banks are experiencing a rise in Stage 2 loans, indicating a need for improved loan portfolio management and increasing potential for market-oriented actions.
3. Declining asset quality sentiment: European banks anticipate continued pressure on asset quality, with rising costs of risk and higher loan losses expected in the future.
4. NPL stocks continue to fall: While the total stock of NPLs in Europe has decreased, market trends indicate a potential future increase in NPL volumes.
5. Sector-specific challenges: Sectors such as commercial real estate and specific industries face particular challenges, impacting NPL ratios and overall asset quality.



Spotlight – Greece

Greece NPL market - Pipeline remains strong in Greece with the surge of secondary trades in 2023

- Greece has been one of the most active NPL markets in Europe throughout the last two years, with Greek banks successfully addressing a substantial amount of their distressed debt. Despite this great effort, further NPL books are expected to come to market as the banks target a low single-digit NPL ratio.
- The hugely successful Hellenic Asset Protection Scheme (HAPS), originally launched in 2019 and extended in July 2021, has been instrumental in helping Greek banks to offload their non-performing loans through securitization. Greece has now more than halved its NPL ratio, with the latest figures showing a 4.6% NPL ratio as of December 2022 compared to 25.5% at the end of 2020.
- Each of the four systemic Greek banks have been active in 2022 with Alpha Bank closing a number of large transactions. This is likely to continue through 2023 given the large number of transactions currently ongoing and planned for launch over the coming months. In addition, we are observing an increase in the number of secondary trades being brought to market in 2023 (so far, we have seen c. €5b traded in terms of GBV) and are expecting a healthy pipeline over the next 2-3 years.

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Investors are eagerly deploying capital as Greece’s NPL market presents compelling opportunities for growth. The upward trends in the Greek real estate market as well as, improvements in the legal framework have worked to the favor of servicers in an attempt to offload a portion of their NPLs in order to bring liquidity forward and meet the ambitious goals set by the HAPSs business plans. We have been observing the usual players with experience in the peculiarities of the Greek market as well as, new players eager to transact. On the offering side the landscape is formed by secondary NPL disposals through a mix of either competitive processes or bilateral trades for a mix of portfolio types and thematic portfolio sales (i.e. hotels, vineyards etc.).

The market expects a significant rise in secondary market trades and reperforming loan sales. The introduction of HAPS 3 further enhances the positive outlook for bank deleveraging and future pipeline opportunities.

Stavroula Chronis, Senior Manager, Ernst & Young Greece

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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