Non-performing exposures tracker, Q2 2022

Shining a light on European lending

How is economic uncertainty impacting European banks' asset quality? Is this the beginning of a new credit cycle that will impact Europe's 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 heat map summary — Most major markets are relatively stable

Country	Loan volumes		Loans in Stage 2 (IFRS9)			NPL stock		NPL ratio			Loans with public guarantee	
Country	Total loans (in €b)	Total new loans YoY (%)	Stage 2 stock 2Q22 (in €b)[1]	2Q22 (%)	Stage 2: 2Q22 vs. 2Q21 (%)	NPL stock 2Q22 (in €b)	NPL stock YoY 2Q22 (%)	5 Year Historical max (%)[2]	2Q22 (%)	2Q22 vs. 2Q21 absolute change (%)	Amount (in €b)	% of total loans
France	5,958	2.2%	614.7	10.3%	1.9%	109.7	-7.1%	3.1%	1.8%	-0.2%	105.3	1.8%
Spain	2,854	5.5%	189.9	6.7%	-0.7%	78.9	-5.3%	4.5%	2.8%	-0.4%	99.4	3.5%
Italy	2,015	2.3%	273.9	13.6%	0.2%	51.8	-30.1%	11.1%	2.6%	-1.1%	123.2	6.1%
Germany	3,020	11.5%	326.6	10.8%	2.4%	30.2	-3.4%	1.9%	1.0%	-0.1%	11.5	0.4%
Netherlands	2,056	7.2%	139.6	6.8%	-0.2%	27.2	-18.9%	2.4%	1.3%	-0.4%	3.1	0.2%
Greece	218	0.8%	27.7	12.7%	-0.5%	11.3	-62.7%	45.3%	5.2%	-9.6%	5.1	2.3%
Portugal	226	2.8%	26.9	11.9%	0.0%	7.5	-15.6%	15.2%	3.3%	-0.9%	7.5	3.3%
Ireland	292	7.5%	31.9	10.9%	-5.2%	7.0	-18.6%	10.5%	2.4%	-1.0%	0.8	0.3%
Poland	133	2.9%	16.1	12.1%	-0.7%	5.7	-11.3%	6.8%	4.3%	-0.9%	4.8	3.6%
Cyprus	34	3.8%	5.4	15.6%	-1.5%	1.2	-58.9%	38.9%	3.6%	-5.5%	0.0	0.0%
EU/EEA*	20,500	6.8%	1,939.2	9.5%	0.6%	371.1	-16.1%	4.1%	1.8%	-0.5%	365.1	1.8%

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 European Banking Authority (EBA)
[2] Countries in order of NPL stock - 5 year max for the period 2017 to 2022
* European Economic Area (EEA)

Negative: high   Watch list: medium   Stable: low

Source: EBA 2Q22

This edition of the tracker focuses on five key findings:

1. Macroeconomic deterioration is now evident.

Most banks had already accounted for the effect of the economic challenges (i.e., interest rate environment, inflation and fears of economic slowdown) by increasing provisions.

Economists are revising their 2022 and 2023 economic growth forecasts. Consumer and business confidence levels are near record lows in many countries, and European economies continue to be negatively affected by the war in Ukraine. For instance, at the time of writing, the European Commission forecasts economic growth of 2.7% in 2022 and 1.5% in 2023 (down from 4.0% and 2.8% previously expected in the winter 2022 forecast). Annual average inflation for 2022 is projected to peak at a historic high of 8.3% in the EU, before easing to 4.6% in 2023.

Based on the EY review of European banks (see Exhibit 2), EY teams concurred banks with exposure to Russia had replaced significant COVID-19 pandemic overlays with new overlays related to Russia and current macroeconomic uncertainties. As of Q2 2022, most banks have replaced their pandemic related overlays with newer overlays in response to increasing inflation (especially in Spain and the UK) and cost-of-living risks.

2. Europe's Stage 2 classified loans are growing again.

Data on international financial reporting standards (IFRS) loan categories shows that European banks' ratio of Stage 2 loans (those performing but with increased risk) amount to €1,939b, growing from 9.1% in 1Q22 to 9.5% in 2Q22. This marks a reversal of the decreasing trend seen throughout 2021, following the peak of 9.1% reached in 4Q20. The key European markets driving the quarter-on-quarter (QoQ) increase in Stage 2 provisioning ratios are Germany (+1.5%), France (+1.0%), Italy (+0.5%) and Cyprus (+0.1%). Conversely, Portugal (-0.8%), Ireland (-0.7%), Netherlands (-0.6%), Poland (-0.5%), Greece (-0.5%) and Spain (-0.5%) saw a decrease in Stage 2 classified loans.

Stage 2 loans may now represent 9.5% of the overall European loan book, but the ratio of Stage 3 loans (those that are non-performing) has decreased by slightly less than 0.2% QoQ and fallen by 0.6% year-on-year (YoY), as shown in Exhibit 4 below.

The increase in the relative and total level of European Stage 2 provisioning occurs against the backdrop of an overall decline in the stock of NPLs. YoY comparators show an average decrease of 16.1% across Europe in NPL stock. In addition, the origination of new business continues to grow, with a 6.8% overall increase in new loans across Europe for the year to date when compared with the prior year.

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

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

In line with the previous EY report, EY teams have conducted a review of European banks' earnings call transcripts for 2Q22 (see methodology for details) to better understand their views on credit markets and NPE volumes.

The overall message from the EY research is that most European banks are beginning to expect an inflow of NPLs in the short-term — even though the EEA NPL ratio has fallen to 1.8% (see Exhibit 1 for further details). More specifically:

- Based on the data collected, it appears that French, German and Dutch banks have the greatest short-term expectation of increasing NPLs. The Spanish and British banks that predicted higher NPL inflows in the previous quarter now expect a stable outlook, after cautiously increasing provisions in 1Q22. According to the credit conditions survey conducted by the Bank of England during 3Q22, British lenders saw the net percentage balance for changes in default rates on secured household lending increase slightly in Q3. This is expected to increase in Q4 for secured, unsecured and corporate lending to businesses of all sizes. Similarly, the Bank of Spain warned in early April of an increase in delinquencies due to the deteriorating macroeconomic conditions. Subsequently, NPL ratios have led to the tightening of credit terms on newly underwritten loans.
- Small-and medium-sized enterprise (SME) lending across the UK and the European Union is expected to witness further defaults as increasing utility, rent and labor costs make it harder for SMEs to service their debt obligations. In addition, consumer lending will experience major uncertainties over unemployment rate increase. EY teams have already started to observe falling collection and recovery rates by debt collection agencies (DCAs).
- The banks included in the EY exercise are evenly divided between those forecasting a stable or lower level of NPLs in the immediate future, and those expecting a higher level. This seems to indicate that while NPL volumes are still expected to grow, the extension of government support into 1H22 is limiting pandemic-driven NPL volumes for originators. The impact of government support is discussed below.
- In contrast, most banks' cost of risk has stabilized, similar to the previous quarter. However, three exceptions are that some banks in the UK, France and Netherlands now have a higher cost of risk.
- Provisions increased across European banks. Banks have updated their risk models to reflect the change in credit and market risks, and have thus increased their provisioning requirement as the region continues to be challenged with increasing inflationary pressure leading to a "cost of living" crisis in various countries.
- Higher loan losses are expected, but below the peaks of the financial crisis. Recession and higher borrowing costs are likely to push up impairments on all forms of lending. The EY European Bank Lending Forecast predicts that loan losses across the Eurozone will rise to 3.9% in 2023, above 2.2% in 2021 and the peak of 3.2% in 2019. However, this is still lower than the 6% average seen between 2012–19.

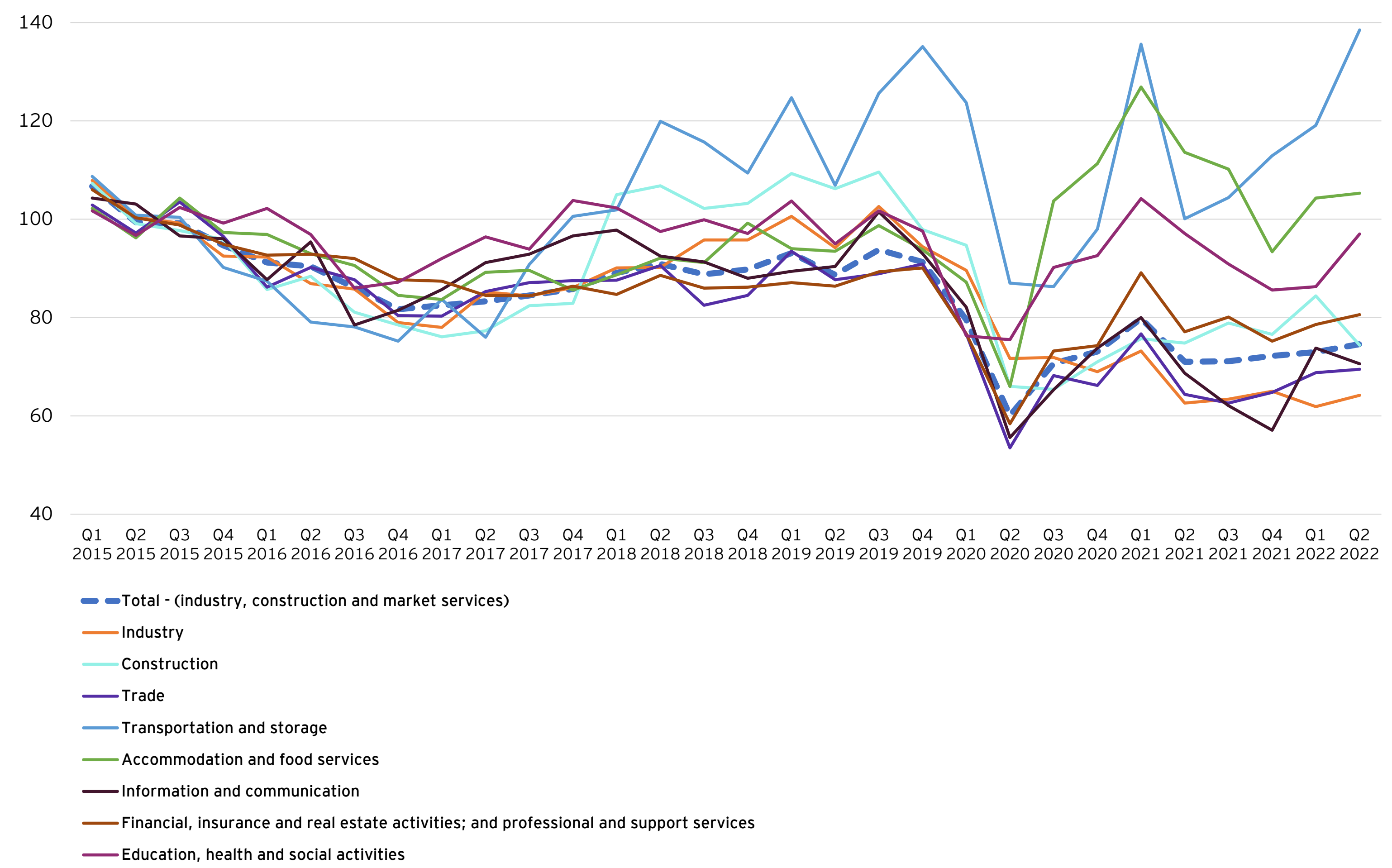
Exhibit 2: European banks' NPE outlook continues to be positive (reporting season 2Q22)

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

Source: EY analysis Q2 2022

Exhibit 3: EU declarations of bankruptcies trend

EU (available countries)
Declarations of bankruptcies of businesses by activity, 1Q15 to 2Q22*
(2015=100)
*Seasonally adjusted



Source: Eurostat 2Q22.

European banks' potential credit losses continue to remain under control, as illustrated by the decrease in Stage 3 provisions. In part, this is due to moratoriums and government support ensuring that defaults have yet to materialize.

However, as Exhibit 3 shows, 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, such as hospitality and leisure. Commercial bankruptcies are a potential indicator and overall bankruptcies across Europe increased in 2Q22, with transportation and storage, plus education, health and social activities leading the way.

The COVID-19 pandemic has been a key driver of business setbacks in recent periods, especially in hospitality and leisure. During late 2021 and early 2022, energy prices and consumer price inflation led to bankruptcies going up in almost all sectors (particularly in transportation and storage, accommodation, and food, industry and social activities).

In the UK, the Insolvency Service reported a record high number of insolvencies between May 2022 and June 2022, with a 13% increase on the previous quarter and 81% YoY growth. Corporate insolvencies remained low during the COVID-19 pandemic due to government support, but are now being driven by soaring expenses as a result of the energy and fuel crises.

Exhibit 4: Loan composition by stages 2Q22 — Stage 2 loans increased, indicating increase in expected NPLs

Country	Stage 1	QoQ change	YoY change	Stage 2	QoQ change	YoY change	Stage 3	QoQ change	YoY change
Cyprus	76.6%	-2.2%	8.2%	15.6%	0.1%	-1.5%	5.1%	-0.5%	-9.4%
Germany	87.8%	-1.5%	-2.4%	10.8%	1.5%	2.4%	1.3%	0.0%	-0.1%
Spain	90.2%	0.5%	0.9%	6.7%	-0.3%	-0.7%	3.0%	-0.2%	-0.3%
France	87.4%	-1.0%	-1.6%	10.3%	1.0%	1.9%	2.3%	-0.1%	-0.3%
Greece	79.4%	0.9%	9.7%	12.7%	-0.5%	-0.5%	6.4%	-1.9%	-10.7%
Ireland	85.1%	0.8%	6.0%	10.9%	-0.7%	-5.2%	3.9%	-0.2%	-0.9%
Italy	83.2%	-0.1%	1.1%	13.6%	0.5%	0.2%	3.0%	-0.6%	-1.5%a
Netherlands	91.5%	0.7%	0.7%	6.8%	-0.6%	-0.2%	1.7%	-0.1%	-0.5%
Poland	83.3%	0.2%	1.1%	12.1%	-0.5%	-0.7%	4.2%	0.0%	-0.8%
Portugal	83.8%	0.9%	0.7%	11.9%	-0.8%	0.0%	4.1%	-0.2%	-0.9%
EU/EEA	88.2%	-0.3%	-0.2%	9.5%	0.3%	0.6%	2.2%	-0.2%	-0.6%

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%

Source: EBA 2Q22, NPL markets.

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

As detailed in the previous EY 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 had been extended into 1H22. Therefore, some of the impact caused by the pandemic is likely to emerge during the course of the current year.

Evidence of the unwinding of government support comes from loans outstanding with expired moratoriums, which stand at €615.9b as of 2Q22, 3.0% of the total loan volume. Of these loans, 6.2% are non-performing, indicating strong exit performance after the moratoriums.

Loans with a public guarantee have remained relatively flat at €365.1b (1.8% of the market). A key issue for publicly guaranteed balances is the range of definitions and criteria set by local governments. Therefore, it is expected that as government support falls away, elements of these balances may not enter performing status, which could generate future NPL volumes for European banks.

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

Across Europe, the total stock of NPLs in 2Q22 was €371.1b. This represents a 3.5% decrease QoQ and a 16.1% YoY fall. France remains the largest contributor to the region's NPLs (€109.7b), followed by Spain (€78.9b) and Italy (€51.8b). Collectively, these markets account for 65% of Europe's NPL stock by value.

The European NPL ratio was 1.8% in 2Q22, a 0.1% decrease from 1Q22. Noteworthy countries' NPL ratios include Greece (5.2%), Poland (4.3%), Cyprus (3.6%) and Portugal (3.3%). 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 secondary markets, with the availability of capital to purchasers enabling significant portfolio transactions to take place. In addition to this, jurisdictions, such as Greece and Italy, benefit from government-backed securitization schemes with volumes accounting for €40b in 2021 and €14b in 1H22 — which itself represents 40% and 28% of the total NPL volumes transacted in each period respectively. These aid sales by bridging the pricing gaps between originators and purchasers, which had historically been a hurdle to completing transactions.

A second driver, 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, it is likely that a proactive NPL management approach will continue to remain at the center of European banks' NPL strategies.

During 1H22, EY teams have seen financial institutions and nonbank lenders reassess their operations based on factors, including movements in financing rates, determinations of noncore products and the wider distress that they expect to follow the end of the pandemic. Current market dislocation has led a number of portfolio transactions to be put on hold, with pricing impacted by widening bid-ask spreads. Despite the uncertainty, portfolio transaction levels have remained high. EY teams are currently seeing some sellers putting deals on hold until 2023, but others are still coming to market to capitalize on current prices ahead of potential price reductions due to macroeconomic deterioration.

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

Asset type	Cyprus	Germany	Spain	France	Greece	Ireland	Italy	Nether-lands	Poland	Portugal	EU/EEA
NPL ratio	3.6%	1.0%	2.8%	1.8%	5.2%	2.4%	2.6%	1.3%	4.3%	3.3%	1.8%
- Households	10.0%	1.4%	3.6%	2.2%	9.6%	3.6%	2.7%	1.0%	3.8%	2.3%	2.2%
- Mortgages	9.8%	0.7%	2.7%	2.0%	8.4%	3.3%	1.9%	0.8%	2.0%	1.3%	1.6%
NFC*	3.9%	2.2%	4.4%	3.3%	7.7%	5.5%	4.4%	3.2%	6.0%	8.0%	3.4%
- SME	4.1%	2.4%	6.7%	3.9%	12.6%	9.0%	6.1%	3.4%	7.6%	8.6%	4.4%
- CRE**	3.8%	2.1%	8.3%	3.0%	14.3%	11.2%	9.0%	2.9%	8.9%	13.1%	4.2%

NPL ratio

NPL ratio >15%

NPL ratio < 5%

NPL ratio between 5% and 15%

Source: EBA 2Q22
National Finance Corporation (NFC)*
Commercial real estate (CRE)**

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The Spanish market for debt portfolios and real estate owned (REO) has been very active in 2022. Investment volumes recovered to pre-pandemic levels (€9b) and financial institutions yielded historical low delinquency figures. With regards to the type of portfolios, the assets most transacted have been unsecured portfolios (48%) together with granular portfolios of individual mortgages (23%), spurred on by the good performance of the Spanish residential market and reperforming loans or RPLs (14%).

The rises in interest rates and inflation that has been anticipated during 2022 will have an entrenched impact in the second half of 2022 and 2023 as follows:

- On the one hand, the rise in interest rates is making financing more expensive — a key element in some of these operations to reach the expected returns — which may cause a slight adjustment in prices and a decrease in the optimal sizes of the portfolios up to average sizes of around €250m.
- On the other hand, the rise in financial costs together with the inflation of costs — mainly electricity and gas — may cause a significant increase in defaults and debt refinancing — both at the level of individuals and SMEs — which will impact the levels of delinquency of financial institutions, encouraging the sale of this type of portfolio.

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The German market can currently be seen as a boat in a harbor ready for a turn on a stormy sea. Banking professionals are currently expecting rising NPL ratios for the upcoming years due to oppressive macroeconomic effects of rising interest rates, the uncertain geopolitical situation, commodity and energy crises, supply chain disruption, and inflation. Borrowers that made use of the state aid COVID-19 loans must consider the macroeconomic uncertainties and changing interest environment because those loans will be due soon, and must be refinanced. In addition, the rising costs of living and the high inflation will impact the ability of several private individuals to be able to service their loans.

As a result, the upcoming years may be a turning point for NPL transactions, since multiple banks should be ready to leave the starting blocks in the race to navigate through the crisis and to achieve further potential through asset realization. As always, the motives vary. Several banks still need to free liquidity, capital and resources; and make strategic decisions to concentrate on core business or portfolio optimization. Regardless of the objective, financial institutions will face an increasing pressure to keep reshaping their balance sheet and new approaches need to be adopted to unlock portfolio sales.

On the one hand, the current crisis has created a greater imbalance between the intention to sell and the appetite to purchase. This turned out in a number of bilateral transactions that were not announced publicly, as well as a small number of portfolio transactions that were well below market expectations — both in volume and in size. On the other hand, we have observed signs of a first small wave in the second half of 2022 with several portfolios traded at the same time, as demand for German NPL portfolios remains high. The traded portfolios were primarily written-off legacy portfolios that allow the banks to clean up their workout units before year-end and to be prepared for the expected rising restructuring cases.

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At an aggregated European level, SME and commercial real estate loans continue to have the highest NPL ratios, at 4.4% and 4.2%, respectively. Collectively, all nonfinancial loans still have higher NPL ratios than loans to households (3.4% compared with 1.8%).

A look at different sectors of the economy shows that each sector's overall NPL ratio decreased between 1Q22 and 2Q22. Notable sectors from an NPL ratio perspective continue to be accommodation and food service activities (8.7%); arts, entertainment and recreation (7.2%); construction (6.8%); and mining and quarrying (5.4%). All the other sectors covered by the European Central Bank had a reported NPL ratio 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. Based on the latest market communications, European banks' asset quality sentiment is slowly declining and continued pressure in future quarters is likely.
3. Government support and moratoriums continue to delay NPE creation across European banks, but are expected to mostly end in FY22.
4. Looking ahead, it is likely to see NPE volumes increase as market effects of geopolitical events are felt, especially in energy and consumer sectors of the economy. Banks' ability to identify these macro trends and respond accordingly remains critical.

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 EU, by looking at the evolution of risk indicators (RIs) from 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, moratorium programs, public guarantee schemes and the overall macroeconomic situation.
- In addition, to follow the pandemic's impact on European banks, EY teams have tracked earnings call transcripts for 21 European banks to identify banks' current views in terms of NPLs or NPEs, asset quality performance, stage provisioning, and NPL formation or 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.
- EY teams have a strong internal network, breadth of knowledge and vast array of credentials covering different macroeconomic landscapes.

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