Special Report

Asset Quality Trends and Risks across European Banks

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Executive Summary

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European banks' exposure to small and medium enterprises (SMEs) and mortgages significantly increased during the pandemic.

- Accommodative monetary and fiscal policies boosted SME and mortgage loan growth.
- Low-interest rates, excess household savings and preference for spacious houses boosted mortgage demand. However, disruptions in the supply of houses led to overvaluation in house prices.
- SME loan growth was mainly driven by the Public Guarantee Scheme (PGS) loans.

02

Non-performing loans (NPLs) volumes and ratio continue downward momentum.

- The reduction in NPL was mainly driven by disposals in the secondary market and government-backed securitisation schemes.
- The reduction in NPL ratio was observed across the sectors affected by the pandemic.
- The hospitality and leisure sector, which were adversely affected by the pandemic, recovered slower than other sectors.

03

Elevated levels of stage 2 loans and overvaluation in house prices lead to vulnerability on asset quality.

- Stage 2 loan ratio is materially above the pre-pandemic level and is concentrated in non-financial corporate (NFC) exposure, especially SMEs and commercial real estate (CRE).
- An increasing share of loans under support schemes are being recorded in stage 2.
- The overvaluation in house prices increased the risk of price correction in the medium term. Countries with high household indebtedness and declining household income are more vulnerable to price correction.

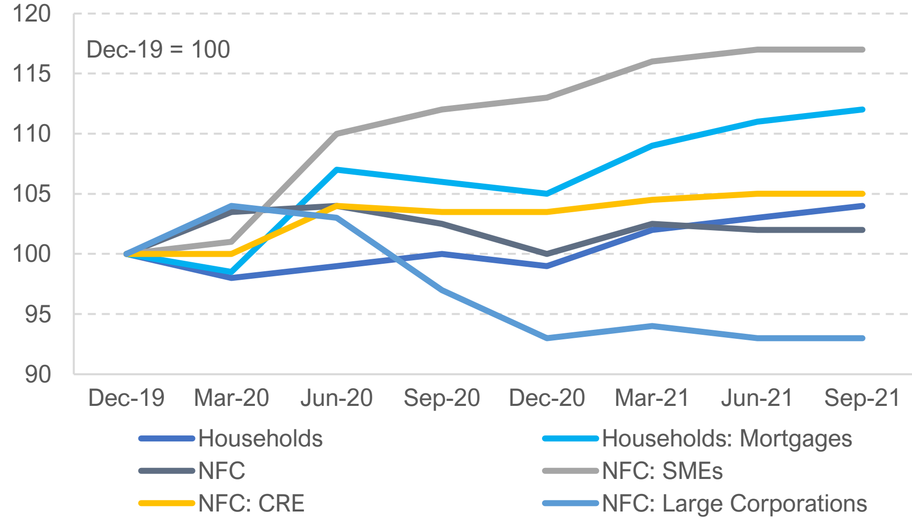
04

Banks remain cautious in loan provisioning

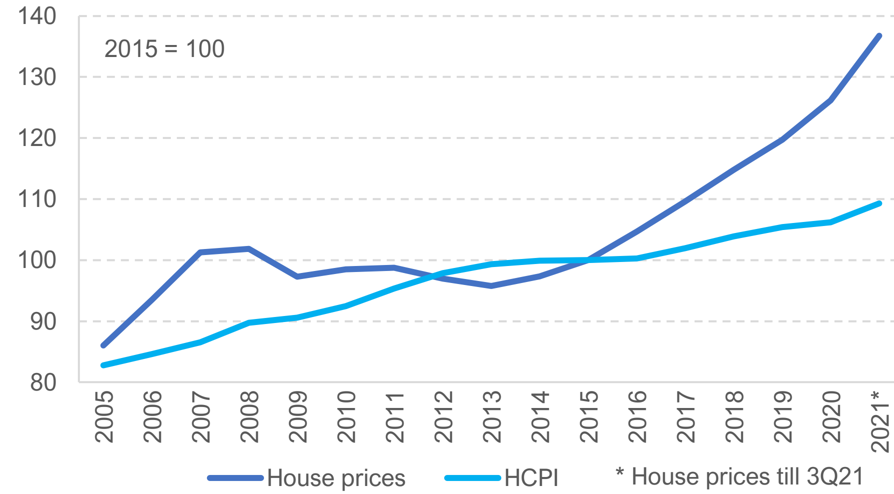
- European banks' cost of risk trended towards the pre-pandemic level, driven by improvement in macroeconomic conditions, low NPL levels and higher loan recovery.
- Provisioning for performing exposure increased materially compared with the pre-pandemic level.
- Provisions for performing CRE and SME loans increased the most due to PGS and negative development in the CRE segment.

Banks Significantly Increased Exposure to SMEs and Mortgages during Pandemic; Strong Mortgage Demand Accelerated Inflation in House Prices

Fiscal expansion boosted SME and mortgage loan growth



EU house prices increased 14% starting Dec-19



- European banks' exposure to mortgages and SMEs increased markedly since the onset of the pandemic. Low interest rates, accumulated household liquidity and preference for suburban and more spacious houses boosted the demand for mortgages. Labour shortage, global supply chain bottlenecks and inflationary pressure on input prices weighed down on the sector's ability to expand housing supply, thus putting upward pressure on house prices. House prices have been increasing since 2015 on accommodative monetary policies. However, the ultra-accommodative fiscal and monetary policies during the pandemic accelerated the increase in house prices.
- Exposure to SMEs grew significantly with the onset of the pandemic, largely due to support measures such as Public Guarantee Scheme (PGS) loans. PGS represented more than 60% of the SME loans granted. SMEs were highly affected by the pandemic and had limited access to market funding, making them reliant on bank finance to meet liquidity needs.
- Lending to large corporates declined due to their reduced appetite for fixed investment amid macroeconomic uncertainty, increased access to capital markets and repayment pressure on credit lines drawn at the onset of the pandemic.

Source: *EBA Risk Dashboard January 2021; Eurostat*

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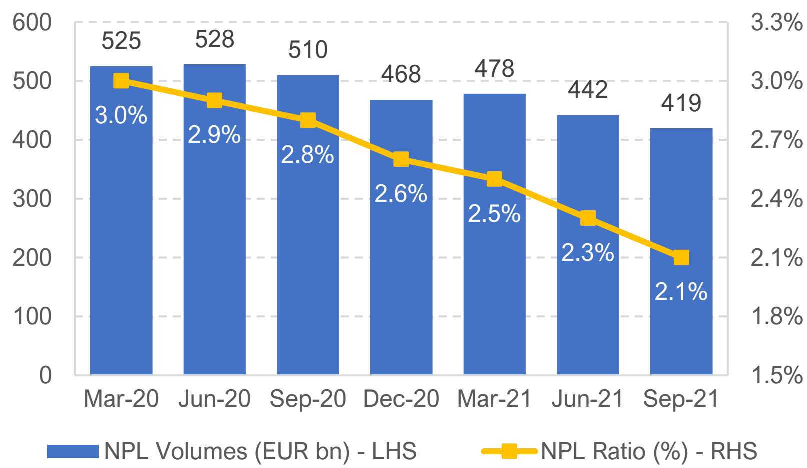
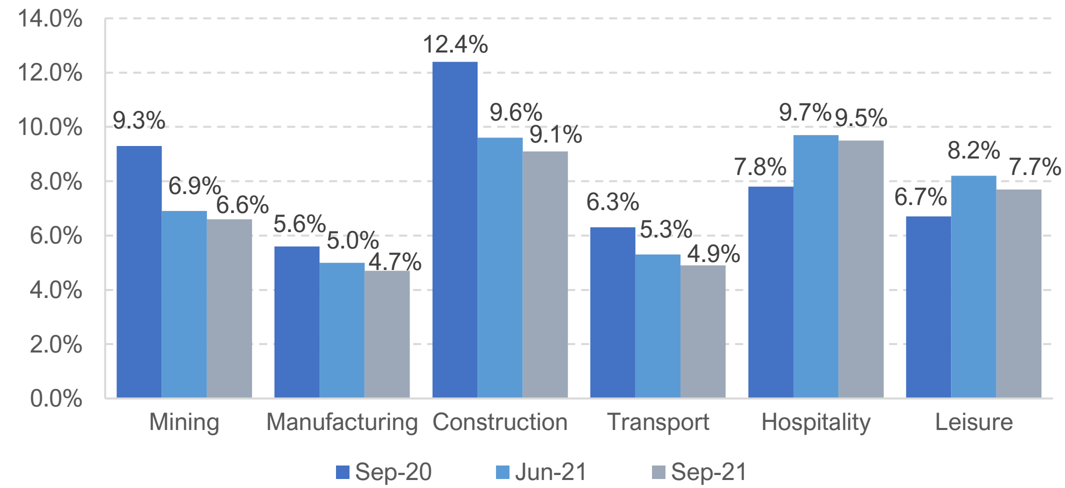
NPL Ratio of European Banks, Including Most Affected Sectors, Improved

NPL ratio continues downward momentum



Hospitality and leisure slow to recover among affected sectors

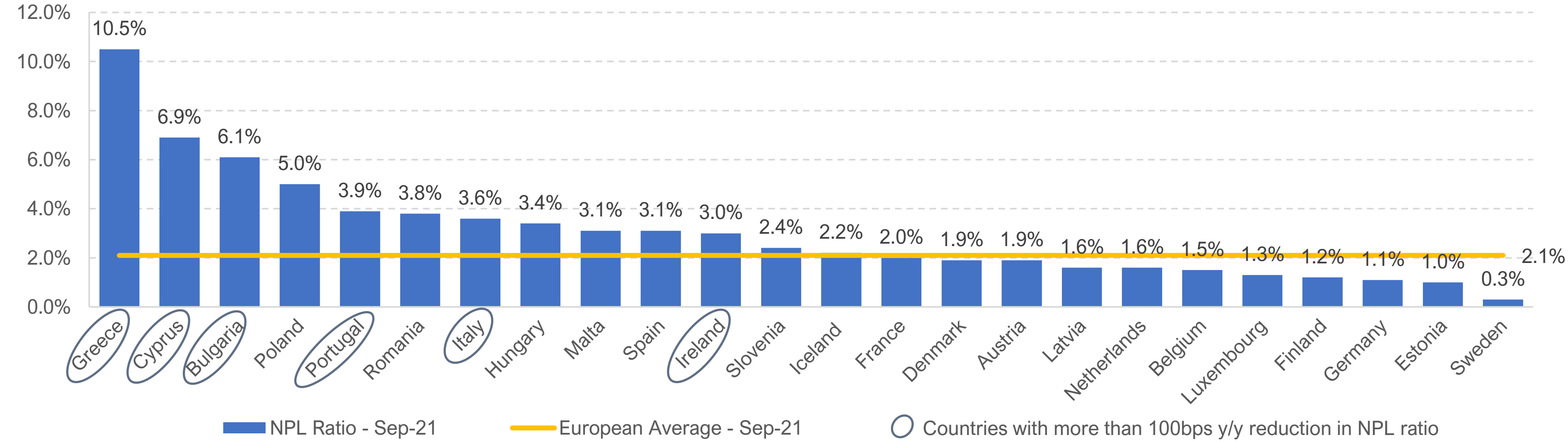


- European banks' NPL ratio maintained its downward trend and declined to 2.1% in Sep-21, reflecting reduction in NPL volumes, which was largely driven by disposals of NPLs in the secondary market and government-backed securitisation schemes.
- The sectors most affected by the pandemic, such as mining, manufacturing, construction and transport, recovered strongly on improvement in economic activities as well as rising demand for houses and consumer goods.
- The hospitality (accommodation and food services) sector, which was adversely affected by the pandemic, reported a slight decline in the NPL ratio compared with that in the previous quarter. However, the ratio remained above the Sep-20 level. Notably, banks in Cyprus, Greece, Croatia and Malta have the highest exposure to hospitality, which represents more than 10% of their loans and advances. Tourist activities in these countries increased in 3Q21, which contributed to the decline in their NPL ratios.
- A similar trend was observed for the leisure (arts, entertainment and recreation) sector. However, exposure to the leisure sector is extremely low across Europe. Only banks in Greece, Malta, and Portugal report more than 1% of their corporate exposure to this sector.

***Source:** EBA Risk Dashboard January 2021*

Some European Countries Recorded Material Reduction in their NPL Ratio

NPL ratio is highly concentrated in few European countries

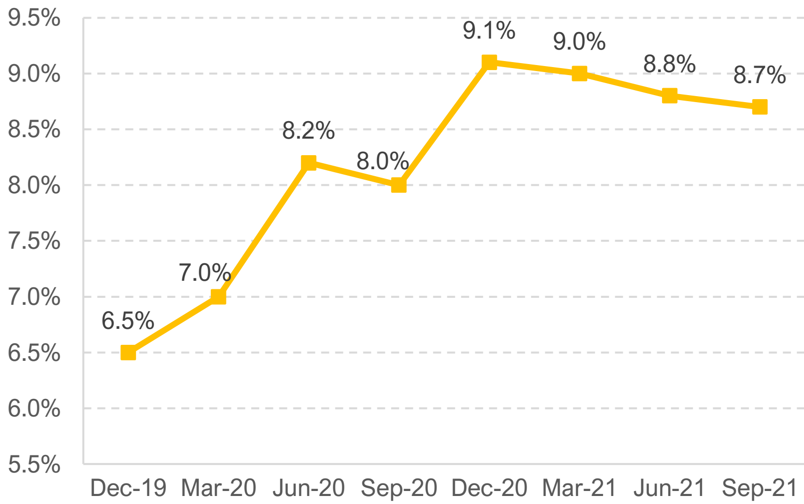


- The dispersion of the NPL ratio is very high among European countries, with Greece reporting the highest NPL ratio of 10.5% and Sweden the lowest ratio of 0.3%.
- Notably, Greece's NPL ratio has improved materially over the year, reducing to 10.5% in Sep-21 from 28.8% in Sep-20, led by the successful execution of government-backed securitisation scheme – 'Hercules'. Other countries recording more than 100bps y/y reduction in their NPL ratios in Sep-21 include Cyprus (-740bps), Bulgaria (-110bps), Portugal (-160bps), Italy (-180bps) and Ireland (-100bps). The reduction in Italy's NPL ratio was also driven by the government-backed securitisation scheme, Garanzia Cartolarizzazione Sofferenze (GACS).
- Spain was the only country to register a 10bps y/y increase in its NPL ratio in Sep-21, while that for Poland and Denmark remained stable compared with that in Sep-20.

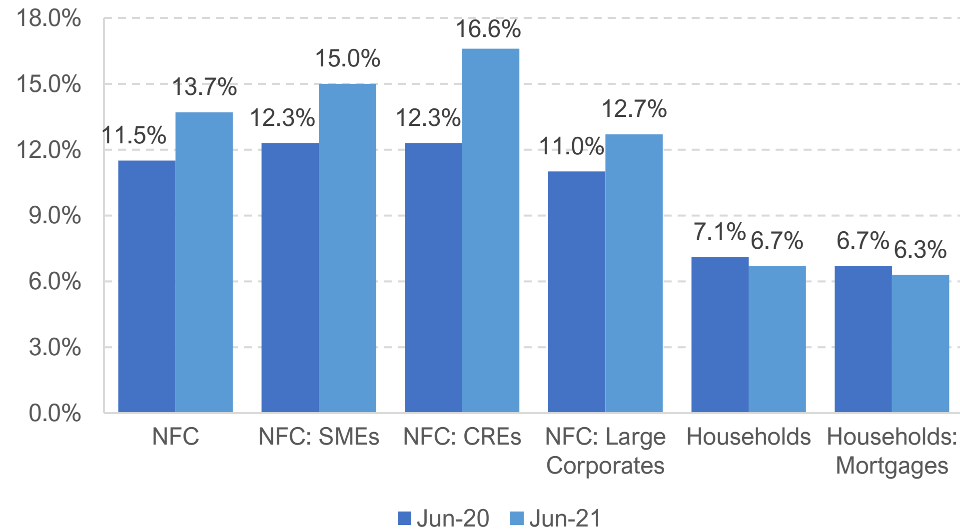
***Source:** EBA Risk Dashboard January 2021*

However, Stage 2 Loans Elevated, Representing Key Potential Risk to European Bank's Asset Quality

Stage 2 loans ratio materially above Dec-19 level



Stage 2 loans ratio increased for all NFC exposure*



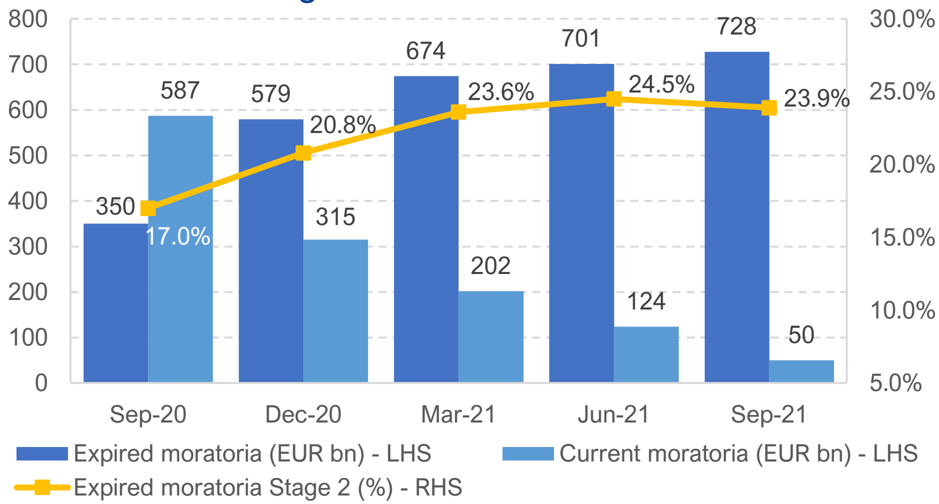
- Stage 2 loans (performing loans but with a significant increase in credit risk since initiation) slightly declined on q/q basis but remained materially above the pre-pandemic level (Dec-19).
- The concentration of stage 2 loans is mainly in non-financial corporate (NFC) exposures, especially small and medium enterprises (SMEs) and commercial real estate (CRE), the two riskiest segments.
- Notably, since the onset of pandemic, highly indebted firms opted for loan support schemes (loan moratoria and public guarantee schemes (PGS)) in greater numbers than did companies with low level of indebtedness.
- The asset quality of loans under such support schemes deteriorated since their inception, and an increasing share of these loans are being recorded in stage 2 loans.

***Source:** EBA Risk Dashboard January 2021*

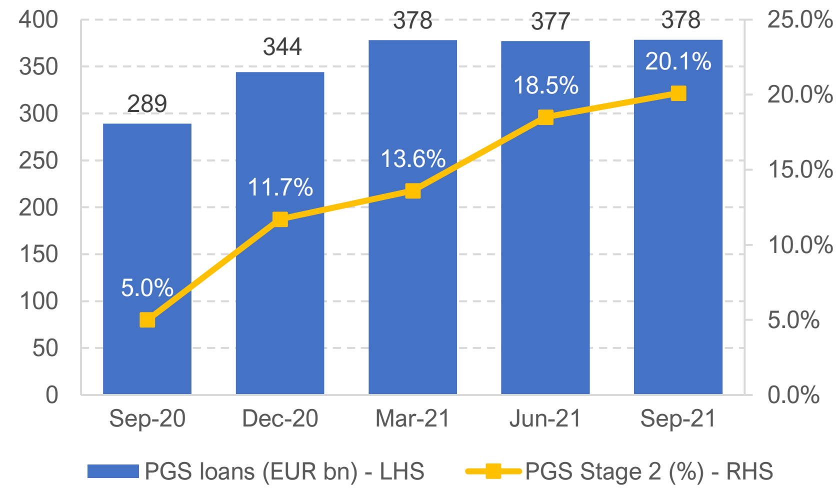
**Data available only till June 2021*

Increasing Share of Support Measures Loans Recorded in Stage 2

Expired moratoria stage 2 loans at elevated levels

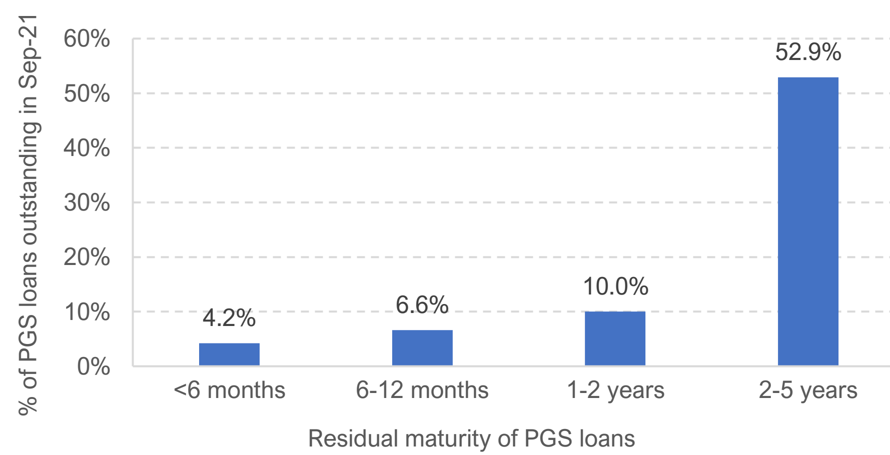


Steep rise in PGS stage 2 loans



- As of Sep-21, only loans of EUR 50b were under moratoria, drastically down from EUR 587b in Sep-20. Although the stage 2 loans ratio for loans under moratoria declined marginally in Sep-21, it remains elevated.
- Loan volumes under PGS stabilised at EUR 378b in Sep-21 as the government gradually terminated these schemes. However, PGS stage 2 loans continue to increase, reaching 20.1% in Sep-21.
- The total rundown of moratoria in the upcoming quarters is likely to contribute to the declining trend in moratoria stage 2 loans. However, PGS loans would continue to build pressure on stage 2 loans as a bulk of them would expire after two years.

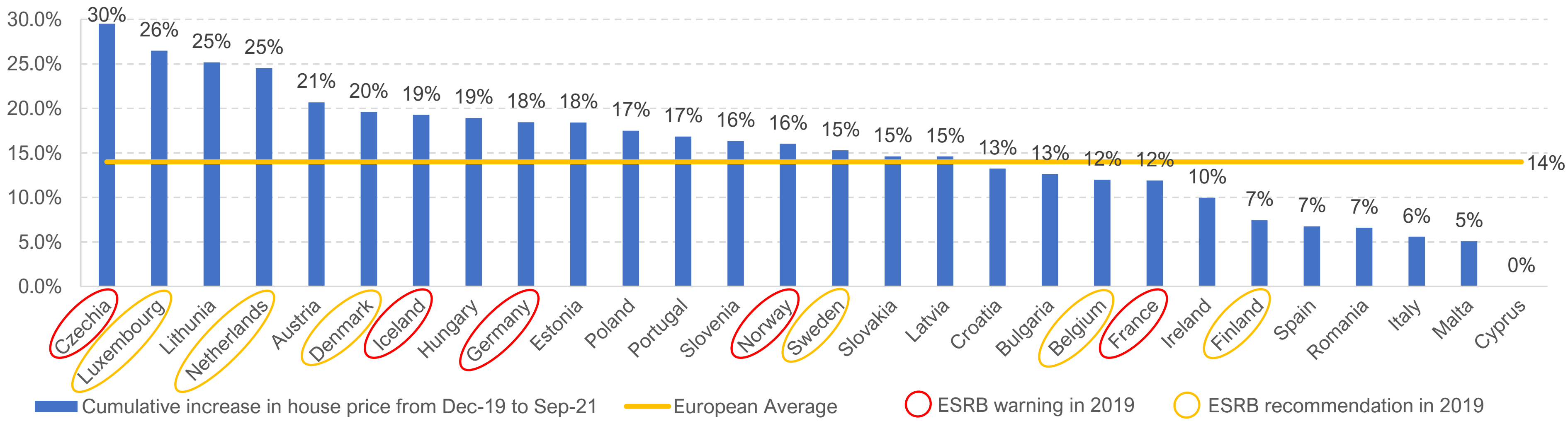
Bulk of PGS expiring after two years



***Source:** EBA Risk Dashboard January 2021*

European Housing Market Heating Up

Cumulative increase in house prices since Dec-19 exceeded 15% in most European countries

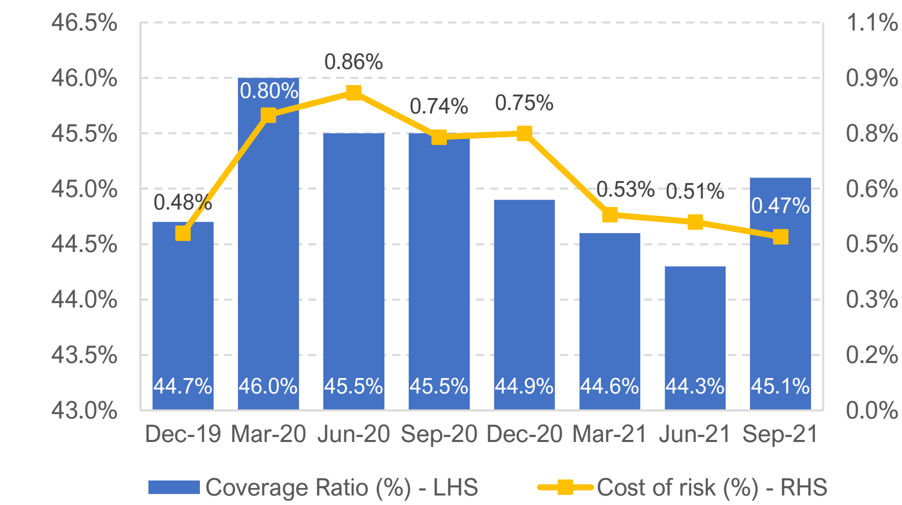


- Strong mortgage demand inflated house prices across most European countries. This increased the risk of price correction in the medium term, which could result in higher defaults and credit losses.
- In 2019, ESRB issued warnings and recommendations to some countries based on the medium-term vulnerabilities related to high/rising household indebtedness, households' ability to repay mortgage debt, growth in mortgage lending, loosening lending standards and valuation in residential prices.
- Countries such as Luxembourg, Sweden, the Netherlands, Czechia and Denmark have relatively high household indebtedness, making them more vulnerable to decreasing household income and/or rising interest rates.
- The European Central Bank (ECB) indicated it would continue its asset purchase programme, although at a step-by-step reducing scale until interest rates are raised. ECB signalled no interest rate hikes until 2023. This indicates that pressure on house prices might continue in the short term.

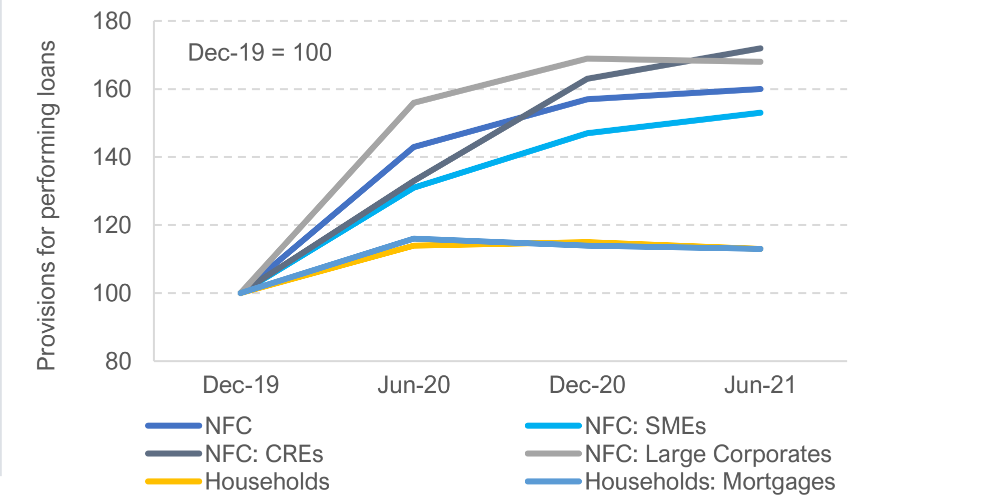
Source: *EBA Risk Dashboard January 2021*

Although NPL Provisions Declined, Banks Significantly Increased Provisions for their Performing Exposure

Cost of risk at pre-pandemic level



Provisions increasing the most across performing NFC loans*



- The average cost of risk (CoR) of European banks trended towards the pre-pandemic level in Sep-21. Some of the reasons ascribed to this decline include government support measures, improved macroeconomic conditions, higher loan recovery and decrease in the stock of NPLs.
- Banks maintain a cautious stance in provisioning for their performing loans. This can be ascribed to the potential impact on asset quality from new COVID-19 variants, uncertain macroeconomic outlook and phasing out of PGS schemes.
- The provisions for performing loans increased markedly for all NFC exposures, especially CREs. Although conditions in CRE markets have improved, the outlook for low-quality buildings remains poor. Factors such as shifts towards e-commerce, remote working, health concerns and strong demand for environment-friendly buildings could decrease prices, rent and collateral values for non-prime properties and low-quality retail spaces. Moreover, over the five years preceding the pandemic, European NFCs as well as insurance corporations and investment funds predominantly purchased non-prime retail and office properties, suggesting exposure to such properties could be substantial. CREs and SMEs represented 6% and 12% of the loan book, respectively, in Sep-21.

Source: *EBA Risk Dashboard January 2021; EBA Financial Stability Review November 2021*

** Data available only till Jun-21*

Expectations on Asset Quality of European Banks

- The NPL ratio of European banks could slightly increase as support measures end. However, an NPL tsunami is unlikely as banks have proactively tightened their credit underwriting standards and risk models, rendering them better positioned to face any further pandemic-related challenges. Greece and Italy extended their government-backed securitisation schemes until October 2022 and mid-2022, respectively, which should notably reduce their NPL ratio.
- Although the stage 2 loans ratio would likely remain above the pre-pandemic levels in the short term, recovery in economic activities and gradual expiration of support schemes will bring down the ratio over the medium term.
- Soaring property prices could lead to some price correction over the medium term. We believe the impact of price correction on the NPL ratio should be manageable given the improving macroeconomic environment and high employment rates in Europe. Also. capitalisation levels remain significantly above the pre-pandemic levels on the back of dividend and share buyback restrictions during the pandemic, providing sufficient cushion to mitigate potential challenges. The increase in interest rates by the European Central Bank and phase-out of government incentives on house purchases such as tax exemptions should cool house prices to some extent.
- European banks have actively set aside sufficiently higher provisions compared with those in the pre-pandemic period. Hence, provisioning is likely to remain stable or contained.

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