CAPSTONE PROJECT SUMMARY

Asset Quality Review of the EU and its Riskiest Banking Sectors: Greece, Portugal, and Italy

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Abstract

The asset quality of the EU has been a major focus-point for banks and regulators throughout the last decade. This paper seeks to analyse the past, present and future of asset quality across the EU. Following troubled and uneven recovery in the EU banking system after the 2008 crisis and subsequent sovereign crises since, the findings indicate that the zone has significantly strengthened its asset quality, with its NPL ratio reaching 2.1% at end-2021 (8% in 2014). Previously high-risk systems, i.e., Greece, Portugal, and Italy, have made tremendous progress in off-loading distressed loans from their balance sheets, and their risk-profiles are gradually consolidating closer to EU averages. In these countries, government-backed securitisation schemes through state management have been very successful programs to dispose NPLs, whilst heightened private equity interest has also led to strong demand in the secondary loan market for multi- billion-euro NPL portfolio sales. The EU continues to effectively shape policy to help the transparency and openness of secondary NPL markets to encourage large deal flows.

Despite strong improvement, the main risks in the system today include a potentially large wave lagging defaults from troubled borrowers who were protected by moratorium measures during the pandemic, reflected in the significant share of stage-2 loans across the EU. Furthermore, surging inflation continues to erode the purchasing power of individuals and margins of corporate borrowers, which will translate into hindered repayment capacity for some borrower segments. Overall, these risks are found to be manageable by banks in their current state, although they require careful monitoring.

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Introduction

A bank's credit rating illustrates its' probability of default (PD). Large financial institutions have calculated internal credit ratings for their counterparties since the adoption of Basel II's Internal Ratings Based (IRB) approach. Under IRB, banks (meeting certain conditions) have the discretion to calculate their risk-weighted assets (RWAs) – the risk factor of each asset in monetary terms - and subsequent capitalization using internal methodologies, of which ratings / PD are key inputs (BIS, 2001). This approach can greatly reduce the amount of capital that banks need to retain as it generally produces lower RWA requirements for high quality counterparties, compared to the standardized approach (under which a fixed risk-weighting is assigned to each product/counterparty).

With the importance of internal credit ratings to reduce capital requirements, a key determinant of these ratings for financial institutions (both internal and external), as outlined by Bholat et. al. (2017) is the amount of non-performing loans (NPLs) it holds on its' balance sheet, and the amount of loan-loss reserves (LLRs) it holds against these NPLs. The EBA (2022) defines an NPL as one that has strong indications of default, i.e., if the principal and/or interest payments become more than 90-days past due. Holding a too large stock of NPLs on a bank's balance sheet can be very taxing, reducing earnings through provisioning requirements, depleting capitalization and restricting core lending activities. The asset quality of a bank is primarily measured by its' NPL ratio (NPLs as a percentage of total loans), and to an extent the LLR ratio (LLRs as a percentage of total NPLs). These are key indicators that credit analysts look at during credit risk modelling and analysis. The importance of asset quality should now be clearer; NPL and LLR ratios are the main input for internal ratings, and internal ratings help the bank to reduce the amount of capital it needs to hold, improving its risk profile and financial flexibility. In the scope of external credit ratings, strong asset quality is also very important because external credit ratings are the main determinant of a bank's ability to raise external funds.

The European Union's (EU) banking sector has undergone significant developments in recent years, and in the aftermath of the recent COVID-19 pandemic and current inflationary environment, new threats to asset quality have emerged. Additionally, individual EU sectors remain quite heterogenous, therefore there is a significant delta in the risk profiles of many European banks. The key objectives of the undertaken Capstone project have been to elaborate the understanding of the EU's current asset quality, with specific attention to the riskiest banking sectors of Greece, Portugal, and Italy, whilst also highlighting the current NPL market and its regulatory landscape.

Methods

Using primarily quantitative data obtained from a wide variety of published financial and economic disclosures; central bank economic reports, audited annual reports and quarterly presentations from the banks, and external rating agency reports, the asset quality of the EU on aggregate, whilst also individually for Greece, Portugal and Italy is investigated. To judge asset quality, there is a specific focus on the NPL ratio to assess risk, whilst also inspecting recent trends and evaluating the most significant current challenges.

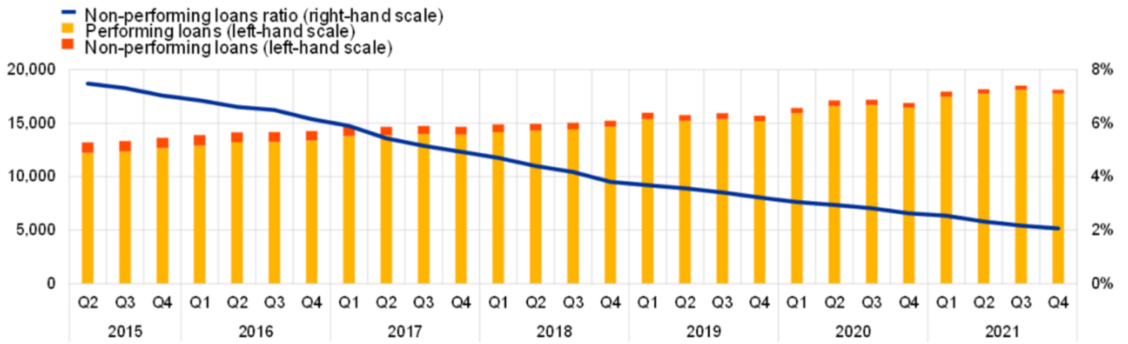
Findings

EU Aggregate Asset Quality

European banks today hold a much more favourable risk profile and stronger balance sheets than in the early 2000s, which led to large losses during the global financial crisis (GFC). Post-2008, the European NPL ratio ballooned from its 3% average to a peak of 8% in 2014 (Huljak et al., 2020), and since, there has been a strong regulatory push by the ECB to reduce the stock of NPLs across the system. The prominent approach to this balance sheet clean-up has been the disposal of NPLs, either through direct sales on the secondary market, or through securitisations into state-owned asset management companies (Deloitte, 2021). As such, the aggregate NPL ratio across the EU has fallen to new lows of 2.1% in 2021 (ECB, 2022) despite significant disruption following the pandemic, clearly following a downward trend since 2015, as illustrated in the chart below. The main area of concern remains elevated stage-2 impaired loans, representing 9% of EU sector loans in FY21 and lagging defaults from the pandemic, coupled with strong inflationary pressures on households and corporations.

Non-performing loans by reference period

(EUR billions; percentages)



Source: ECB.

Greek, Portuguese, and Italian Asset Quality

Since the EU sovereign debt crisis, Greece held the weakest asset quality in the EU, with its NPL ratio peaking at 46% in 2017. After significant deleveraging efforts, supported by the government-backed securitisation scheme in recent years, Greece's NPL ratio now stands at 12.8% (-17% YoY), (Bank of Greece, 2022). In 2021, Greece was the most active offloading EU market with NPL sales of €46bn (Deloitte, 2021), and with significant further transactions scheduled for 2022, the banking sector should be able to meet its strategic target of single digit NPLs by end-2022.

Portugal has seen also a steady decrease in NPL volumes in recent years, with considerable private equity interest in large portfolios of Portuguese banks. NPL ratios have declined meaningfully, reaching 3.6% at YE21, down from 6.5% in 2019 and 11.8% in 2014 (Bank of Portugal, 2021). Loans moratoriums granted during the pandemic have expired in Portugal, without material NPL inflows, though the current inflationary pressures may strain asset quality.

Italy now holds much stronger asset quality than several years ago, reflected in its NPL ratio of 3.1% at YE21 (-1% YoY), edging closer to the EU sector average (Banca d'Italia, 2022). This said, the significant stock of IFRS stage-2 loans (15% of total sector loans) remain concerning, whilst there is also still over €33bn of loan moratorium outstanding to higher-risk borrowers. Additionally, Italy has the second highest Russia-Ukraine exposure in the EU, which may translate into additional asset quality pressures, albeit relative exposure remains small.

Conclusion

Since the 2014-15 distressed-loan peak in the EU, there has been a consistent trend of asset quality improvement across the sector. Banks have engaged in large-scale NPL disposals and securitisations, evident in the current 2.1% NPL ratio across the EU. Government-backed securitisation schemes through state owned asset managers have been very effective at bringing down NPLs in Greece, Italy, and Portugal, closer to EU averages, whilst heightened private equity interest has also led to strong demand in the secondary loan market for multi-billion-euro NPL portfolio sales in recent years. This trend should continue in the near-term, further helped by favourable ECB regulatory changes to reduce information asymmetry and increase transparency in the NPL market, which should translate into higher deal flows.

Nonetheless, the current macro environment has created important risks which may cause asset quality pressures in the near term. There remains a large share stage-2 loans on aggregate (9% of sector loans), representing the doubtful borrower segment who were previously protected from default during the pandemic through support measures. Covid-impacted sectors holding the most significant share of these doubtful loans today. According to ECB data, there is also yet to be an adequate proportional increase in LLR ratios to address this risk. Secondly, the Russia-Ukraine conflict has acted as a catalyst for sharp inflation across the region, addressed by consecutive interest rate rises soon. Whilst most EU banks will benefit from a steepening yield curve in the form of higher interest income, higher interest payables (from debtors) will place additional strain on certain borrower segments. Furthermore, surging inflation continues to erode the purchasing power of individuals and margins of corporations, which will also translate into hindered repayment capacity for some borrower segments.

Overall, these risks do not appear to be of troubling concern at this point, although they require close monitoring over the coming quarters. EU banks, including the previously lagging markets of Greece, Italy and Spain now hold much more resilient balance sheets, which will allow them to absorb moderate inflows of potential troubled loans. Due to efficient EU regulation, the disposal means of EU banks has greatly improved in recent years and troubled banks now several viable options to dispose large NPL portfolios.

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