Credit Research Initiative
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Weekly Credit Brief
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Despite the showcase of resilience, the credit outlooks of banks vary across core and peripheral economies in the EU

by Lee Wei Qi

In Feb 2020, NUS-CRI released a write-up which endorsed the progress that the EU banks have made over the past years of regulatory reforms. Six months down the road, the industry has undergone pivotal developments that have been induced or exacerbated by the Covid-19 Pandemic. According to the International Monetary Fund, the EU is expected to witness a sharp contraction of real gross domestic product (GDP) in 2020. Moreover, the GDP forecast stated that the region would only return to its former high in 2019 by the end of 2022. In light of these, the imperative to re-examine the current profile and future outlook of the EU banking sector[1] has resurfaced.

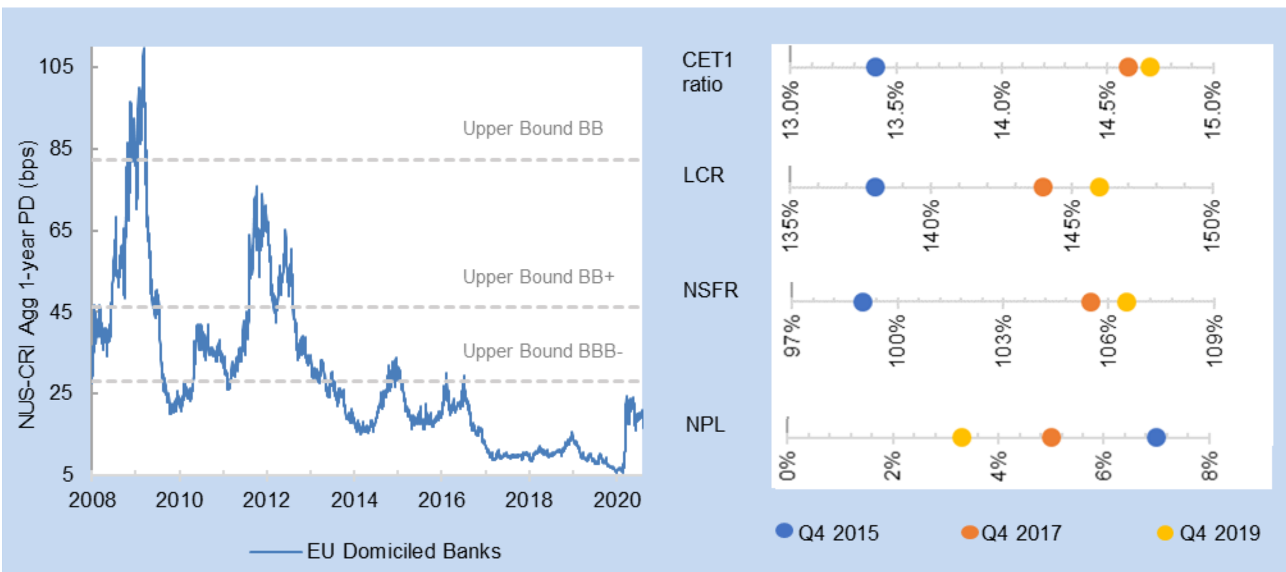

Figure 1a (LHS): NUS-CRI Aggregate 1-year PD of EU domiciled banks from Jan 2008 to Aug 2020 with reference to the PDiR2.0[2] bounds. *Source: NUS-CRI* Figure 1b (RHS): CET1 ratio, LCR, NSFR, and NPL of EU domiciled banks. *Source: European Central Bank*

In the past decade, the EU banking industry has put in tremendous effort into the strengthening of their balance sheets. In the face of a global pandemic, the central focus on building loss-absorbing capabilities has proved to be worthwhile. The EU banks have shown to be resilient amidst revenue and credit pressures posed by the pandemic induced economic slowdown. This was well reflected by the NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) in Figure 1a. Relative to the spike in 2008, Q1 2020 saw a mere increase of 20bps. In addition, the Agg PD for EU banks remained well within the investment grade threshold of BBB- proxied by the NUS-CRI Probability of Default implied Ratings 2.0. The observation aligns with Figure 1b, which displays the quantitative success of a decade of regulatory reforms in the EU region. In particular, the banking sector has cultivated healthier financial books via the reduction of Non-Performing Loans (NPL) and the

[1] The referred universe includes all members of the European Union. This list effectively excludes the United Kingdom.

[2] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation through mapping the NUS-CRI 1-year PDs to the S&P letter grades. The method targets S&P's historical credit rating migration experience exhibited by its global corporate rating pool instead of relying solely on the reported default rates.

development of greater capital strength marked by the increase in the industry's Common Equity Tier 1 ratio, Net Stable Funding Ratio (NSFR), and Liquidity Coverage Ratio (LCR).

Amidst the region-wide lockdown, banks and financial institutions within the EU were able to promptly institute measures that were geared towards mitigating the effects of the following economic contraction. Non-exhaustively, the mitigation responses include the industry-wide call to freeze dividends and pay-outs. Moreover, the European Central Bank (ECB) equipped the banks with the ability to benefit from public guarantees and moratoriums. It has also provided an estimated capital relief of EUR 120bn which could finance over EUR 1.8tn of loans to retail and institutional borrowers. The accommodation in liquidity has substantially helped the EU banks deal with rising loan losses and increasing credit risk that come with the pandemic induced distress.

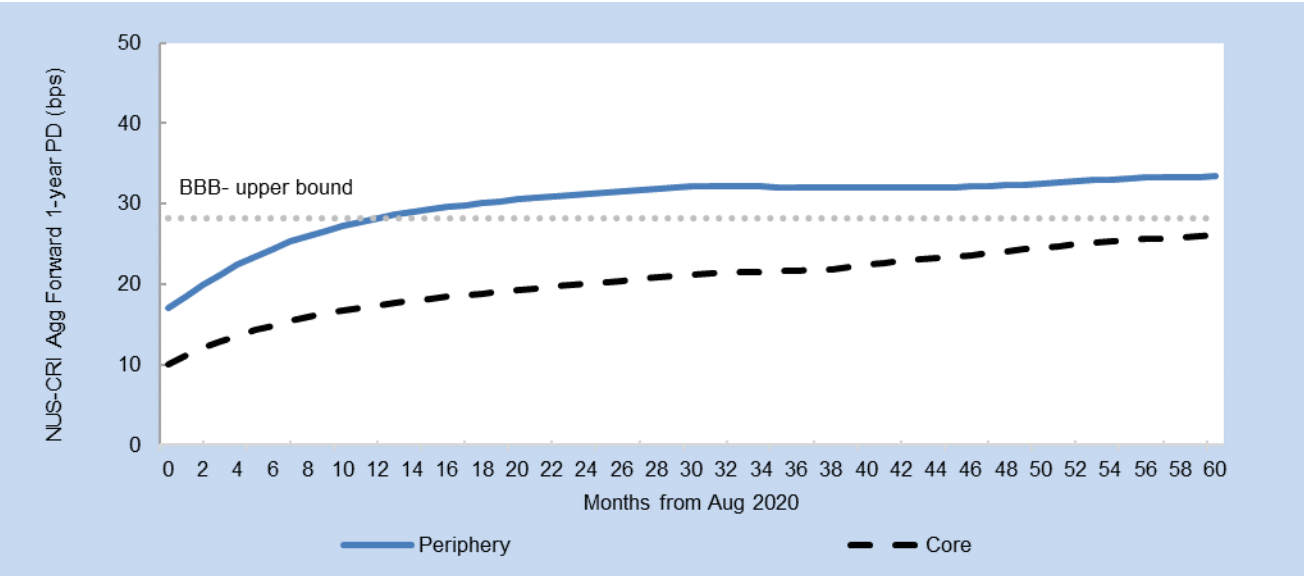

Figure 2: NUS-CRI Agg Forward 1-Year PD of IMF classified Core and Peripheral EU domiciled banks[3] based on data feed as of Aug 2020. *Source: NUS-CRI*

The demonstrated near-term financial flexibility of the EU banks does not warrant throwing caution into the wind. While the EU banking sector as a whole has made tremendous strides in solvency, the improvement in credit across the individual member states is uneven. This variance in capital strength and quality of loan books are reflections of a fragmented financial market. With reduced cross-border flows, it is difficult for the ECB to provide balanced and coordinated initiatives for the entire region. To simplify the illustration of the mentioned differences within the EU banking industry, the classification of Core and Periphery groups is adopted from the referred IMF working paper. Utilizing the NUS-CRI Aggregate (Median) Forward 1-year Probability of Default (Forward PD[4]), Figure 2 found that the Forward PD of the banks from the periphery group is consistently above the Forward PD of the core group across all time horizons. By Aug 2021, the Forward PD of the periphery group has been forecasted to cross into the non-investment grade bound proxied by the NUS-CRI PDiR2.0.

The differences in the Forward PD of the core and periphery groups can be reconciled with data from Table 1. The banks within the peripheral nations are marked by higher proportions of NPLs and lower CET1 ratios. This can be accounted for with fragmentation. The phenomenon has hindered the efficacy of ECB's monetary transmission mechanism. Private interest rates--deposit and lending rates--in the peripheral economies are elevated when benchmarked relative to the corresponding private rates in the core economies or the respective policy rates set by the ECB. As a result, credit is more expensive in the smaller and relatively more distressed economies, where small medium enterprises have substantial shares in terms of employment and economic value-added. This makes it harder for recoveries to take hold. Moreover, it gives rise to a vicious cycle where

[3] The IMF paper classified Core to include Germany, France, and Netherlands and Periphery to include Greece, Italy, Portugal, and Spain.

[4] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similar to a forward interest rate. For example, the 6-month Forward 1-year PD is the probability that the firm defaults during the period from 6 months onwards to 1 year plus 6 months, conditional on the firm's survival in the next 6 months.

balance sheets of otherwise solvent borrowers deteriorate in the absence of affordable credit. All of which would in turn reinforce pressures on the peripheral banks' balances sheets and perpetuate fragmentation within the EU.

	NPL (%) 2019	CET1 (%) 2019	NPL (%) 2022 Forecast	CET1 (%) 2022 Forecast
France	**3.4**	**14.9**	**8.1**	**12.9**
Netherlands	**2.6**	**16.5**	**6.5**	**16.5**
Germany	**2.2**	**14.4**	**4.2**	**14.1**
Spain	4	12	8.4	11.6
Italy	8.9	13.7	13.2	10.2
Greece	40.1	13	47.1	7.7
Portugal	8.3	13.5	11.7	11.4

Table 1: Financial Ratios of EU domiciled banks by countries (Core countries are marked by the bold font). *Source: Oliver Wyman*

To further account for the general rising trend in Forward PDs, it was revealed that the EU is overbanked when benchmarked relative to their peers in Wall Street with almost 2X the ratio of banks to every 100,000 inhabitants. As such, the oversupplied banking sector is found to be plagued with squeezed profit margins and bloated costs. From Q1 2019 to Q1 2020, Return on Equity has fallen from 6% to 1% as Cost to Income has risen from 69% to 72%. The challenge has been compounded by the prolonged negative interest rate environment. According to Oliver Wyman, Net Interest Margin in 2021 is projected to be 8% lower than what it was in 2019. All in all, the fragmented market conditions and uncompetitive operational landscape have provided the ECB with the raison d'être to push for both consolidation and digitalization.

In sum, the EU banking sector has demonstrated formidable strength in growing its solvency. When compared to 2008, the EU banks today have seen a significant reduction in legacy loans and are well-equipped with timely loss mitigation protocols. Given the inherently fragmented and overbanked landscape, the credit outlooks for the banks residing in the core and peripheral sub-regions differ. To ensure that the laggards are either weeded out or reformed, the ECB has taken the seemingly appropriate steps in cross-border M&A and digitalization. Both of which should contribute hand in hand in promoting profit and cost synergies within the industry. With a dragged out recovery process, the pressure is on for the bloc to effectively execute its intent in integrating the EU banking sector.

Credit News

China investors brace for record defaults in risky end to 2020

Aug 23. China's fragile economic recovery is ushering a new dangerous phase for the country's USD 4.1tn corporate bond market as many braces for defaults. Delinquencies have already started rising after a remarkably quiet first half of the year and pressure on borrowers is set to increase as USD 529bn of notes mature by year-end. The reduction of onshore delinquencies early in the year was due to the government encouraging lenders to refinance their debt, accept payment delays, or find other solutions such as swapping bonds for fresh notes with longer maturities. However, with the government starting to dial back financial support, there looks to be more pain ahead especially for property firms, which account for a significant portion of China's high yield bond issuance. (Bloomberg)

Corporate America is choking on debt and imperiling the recovery

Aug 21. Economic recovery in the US may be threatened by the declining profits and increasing amounts of cash that companies will have to pay to their newly acquired debt. Many analysts expect security prices to normalize by next year, though rising debt payments may extend that recovery to two-to-three years. The negative impact of rising debt levels is further amplified by deteriorating sales, which are expected to continue declining until the end of FY2020. As the search for yield continues, near-zero interest rates are pushing investors to invest in high-yield, riskier securities, which has allowed for further borrowing capabilities by the non-investment grade companies. Debt sold in recent months is set to be used for refinancing purposes, though smaller borrowers are being shut out. Rating agencies are taking note of the broad downward trend in credit quality, with more than 80% of S&P 500 companies' corporate earnings per share fell by about 33% in Q2 2020. (Bloomberg)

Revival of Brazil's corporate-bond market lures foreign investors hunting for yield

Aug 18. Foreign investors are flocking to relatively high yield bonds that are offered by big Brazilian corporations. This year, Brazilian corporations have so far raised USD 18.5bn from foreign bond issuance. The high demand for these bonds has been due to the debt-paying better than that of developed countries without too much-added risk. Therefore, many feel that they are underpriced as they trade at excessive premiums relative to the sovereign debt with a very similar likelihood of default. Adding to the appeal, Brazilian corporate-debt issuers come from various sectors, including energy, mining, food supplies, retail and others. That allows investors to diversify without the need to consider different sovereign risks, a rarity among emerging markets. (WSJ)

Covid-19 bonds drive 'sustainable' debt as green issuance fades

Aug 18. According to Moody's forecast, the volume of newly issued debt based on ESG principles could increase by USD 50bn to reach USD 375bn by the end of this year. However, this follows a reduction in the growth of green bonds, the most mature segment of the ESG market. Analysts presume that the reduction in issuance was partly due to a shift in demand for social bonds, specifically, an increased interest in Covid-19 bonds. With a record USD 33bn of social bonds being sold to fund managers in Q2 2020, analysts at Moody's conclude that the "pandemic has increased awareness surrounding social issues related to healthcare and inequality", and will further heighten investors and company's focus on ESG factors. However, caution surrounding 'social washing' has been raised, given that issuers have misappropriated funds raised for 'worthy' causes. (FT)

Yield-starved investors start to rummage in triple C-rated debt

Aug 18. High-risk appetite investors are beginning to look towards high yielding assets that have so far lagged behind the corporate debt rally as high-quality companies are not providing the yield these investors crave. The additional yield above US government debt on corporate bonds with CCC rating or lower have fallen more than 1 percentage point to 12.38% over the last month, increasing bond prices. However S&P Global has still warned that CCC issuers are still vulnerable and require favorable market conditions to pay off their debt. As the US Federal Reserve announced that it would buy corporate bonds in March, strong demand from investors helped to push prices up and yields lower, resulting in returns on top quality debt shrinking. This led to investor's focus now shifting to junk bonds, allowing some of the junk-rated companies to secure cheap funding. (FT)

Virgin Australia bondholders withdraw plans for proposal to rival Bain Capital deal (Reuters)

Institutions pour money into high-yield active strategies (FT)

Carnival's 'strange' bond could leave lenders adrift and unsecured (FT)

Regulatory Updates

Several Fed policymakers see more easing ahead to help brace economy

Aug 20. The Federal Reserve (Fed) has indicated a need for further easing of monetary policy to help nurse the economy through the pandemic. According to the July 28-29 policy meeting, the Federal Open Market Committee (FOMC) saw a deceleration in employment levels, and 'substantial improvement' hinging on 'sustained' reopening of business activity. Furthermore, the committee discussed further easing to promote recovery and to return to the Fed's 2% inflation objective. Another tool in the Fed's arsenal is adopting yield caps and targets, though they agree that such tools 'were not warranted'. Furthermore, FOMC is nearing agreements regarding changes in the Fed's policy framework, adding a 'Statement of Longer-run Goals and Monetary Policy Strategy', which allows the Fed to stick with aggressive policies for longer, while simultaneously increasing transparency and accountability. However, doubts have been raised regarding the impact of such a policy framework change in the short term. (Reuters)

Central banks scale back dollar lending operation as demand drops

Aug 20. US dollar liquidity has been reduced as the European Central Bank, the Bank of England, the Bank of Japan and the Swiss National bank scale back on the emergency swap lines with the US Federal Reserve. The reasons cited is due to the continuing improvements of the US dollar funding conditions and the low demand. This is the second time this has happened since June and has seen short term dollar funding via the Fed's swap lines reduced from a daily occurrence to now once a week. This is a sign of the success of the swap lines measure that has slowed the surge in the dollar exchange rate and eased the equity market sell-off. The total value of swap line loans outstanding from the Fed has dropped from a peak of USD 449bn in May to below USD 100bn. (FT)

China to trial direct foreign investment in interbank bond market (Reuters)

Turkish central bank raises required reserve ratio in latest liquidity step (Yahoo Finance)

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