# Credit outlook of Italian corporates worsens amidst higher sovereign credit risk and tighter financial conditions

by Wang Chenye & Amrita Parab

- **NUS-CRI Agg PD shows a build-up of credit risk in Italian corporates amidst higher sovereign credit risk, the energy crisis, and rate hikes by the ECB**
- **NUS-CRI Forward PD highlights the heightened credit risk of Italian corporates as concerns over their debt sustainability rise in the face of recessionary headwinds**

With interest rate hikes and a plan to withdraw from the Eurozone debt market, the European Central Bank (ECB) has caught the Italian government off guard. Consequently, the sustainability of the Italian government's support to Italian corporates against the energy crisis and recessionary environment has been brought into question. The NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) of the Italy-domiciled corporates has risen steadily since the beginning of the year. Although there was a reprieve in the last two months as investors bet that the possibility of a Eurozone recession would slow the pace of interest hikes by the ECB, the ECB's most recent rate hike invoked an immediate response in Italian corporates' Agg PD. The NUS-CRI Aggregate (median) Forward 1-year PD (Forward PD[1]) underscores a deteriorating credit outlook as it consistently increases over the next 12 months, crossing BBB- upper bound when referenced to PDiR2.0 bounds[2].

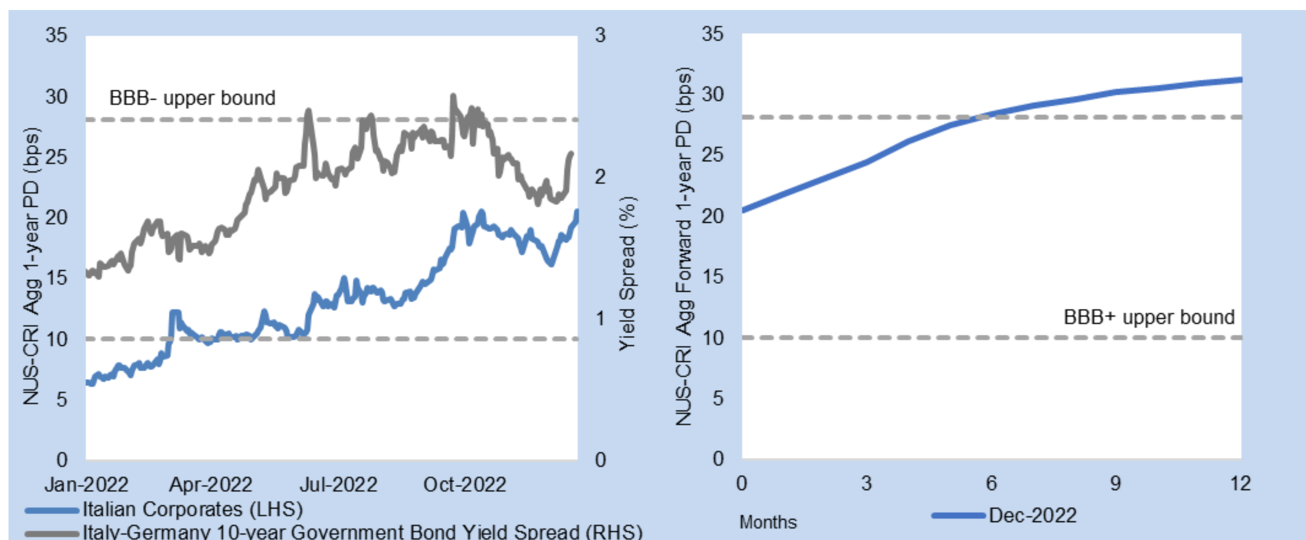


Figure 1a (LHS): NUS-CRI Agg (median) 1-year PD for Italian corporates with reference to PDiR2.0 bounds; spread between Italian and German 10-year government bond yields[3] Figure 1b (RHS): NUS-CRI Agg (median) Forward 1-year PD for Italian Corporates as of Dec-2022, with reference to PDiR2.0 bounds. *Source: NUS-CRI, Investing.com*

During the pandemic, Italy has been one of the biggest beneficiaries of the ECB's quantitative easing scheme, which allowed the Italian government to borrow at lower rates despite its weak financial status. As one of the most indebted countries in the Eurozone now, Italy's public debt reached approximately 1.5 times its GDP. To add to its woes, the ECB's recent 50bps hike to tame inflation has pushed up overall borrowing costs in the Eurozone. At the same time, the ECB also plans to withdraw support to sovereign credit markets by offloading government bond holdings. This move prompted market participants to raise questions over Italy's debt

[1] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similarly 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 18 months – this is conditional on the firm's survival in the next 6 months.

[2] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation through mapping the NUS-CRI 1year 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.

[3] Yield on benchmark 10-year Italian government bond less German equivalent.

sustainability as a majority of its net bond issuance of EUR 250bn over the past two years was bought by the ECB, resulting in a sharp increase in Italian bond yields and widening the Italian-German 10-Year Bond spread to 2.3%. On the other hand, Italy's GDP is forecast to grow by only 0.4% in 2023 as the energy crisis and recession expectations throw a dampener on growth. Italian officials have warned of a credit crunch of EUR 100bn stemming from the weaker economic forecast and the aggressive monetary tightening of the ECB. The Italian government can either follow the ECB's directive to reduce the level of national and corporate debt by withdrawing support for domestic households and corporates, or it can insist on increasing the size of the debt in a bid to spur faster economic recovery. The former approach, however, might starve companies of liquidity in the short term while the latter may be harder to achieve because of higher borrowing costs and as demand is expected to remain subdued in a recessionary environment.

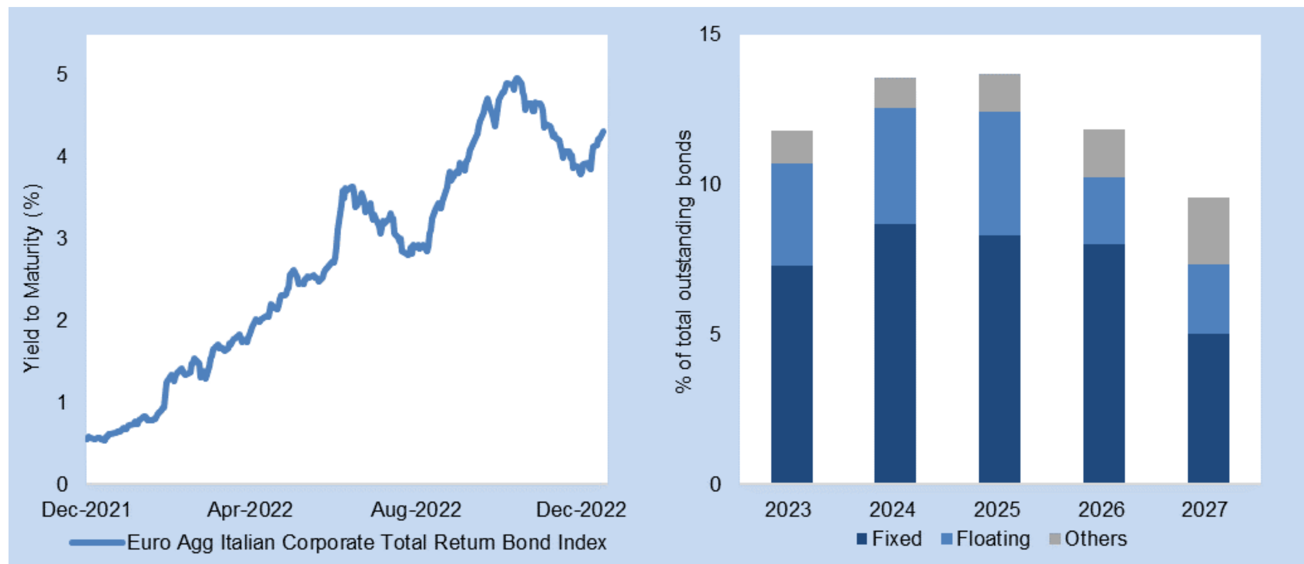


Figure 2a (LHS): Yield to maturity(%) of Bloomberg Euro Aggregate Italian Corporate Total Return Bond Index. Figure 2b (RHS): Maturity distribution of total outstanding bonds of Italian Corporates as of Dec-2022, broken down by type of coupon. *Source: Bloomberg*

Rising sovereign credit risk is bound to have an adverse impact on the credit health of Italian corporates, given the fact that they had the most government-guaranteed debt in the Eurozone, holding a record of EUR 123.3bn state-backed credit lines outstanding as of Jun-2022. As the sovereign credit quality deteriorates amidst the ongoing energy crisis and monetary tightening, the credit quality of corporate debt is also expected to deteriorate. The perceived increase in credit risk is illustrated by the consistent increase in Italian corporate bond yields since the start of 2022 (See Figure 2a). The higher borrowing costs faced by corporates increase refinancing risks as around 40% of their total outstanding debt comes due over the next 3 years. Should Italy's sovereign credit health deteriorate further, corporates may face difficulties attracting investors towards bond issuances, possibly leading to even higher borrowing costs. Also, with around 30% of total outstanding bonds carrying floating rate coupons (See Figure 2b), many companies may already be experiencing a significant increase in their interest burdens.

In addition to difficult financing conditions, Italian corporates are also faced with a tough operational environment. With the average wholesale natural gas price 5 times higher and electricity purchase price 9 times higher than 2019 levels, high input costs remain a major concern for Italian corporates. Energy-intensive sectors, in particular, have borne substantial pressures as higher input costs and contracting demand from households weigh on their bottom lines. Although Italian corporates have received aid packages from the government totaling about EUR 66bn since the start of 2022, these packages only allow the corporates to amortize the costs in a longer term, which means that corporates only postpone the payment pressures and are left with indebted structures. The Italian corporates may even face a liquidity squeeze if the government delays, or even removes subsidies.

Despite the interest rate hikes, the Italian government has just approved the 2023 budget which includes a plan to aid energy-intensive firms and low-income families with around EUR 21bn of subsidies. However, the fiscal deficit is expected to widen further as 60% of the budget is financed by new borrowing. By extending subsidies, the Italian government is counting on renewed growth. However, the sky-high energy bills and receding demand are squeezing corporates' profits, making the growth prospects highly uncertain. At the same time, with ECB policymakers hinting at multiple half-percentage point rate hikes in 2023, Italian bond spreads may widen further should these hikes materialize. A severe widening of bond spreads may prompt the ECB to support Italy via its "Transmission Protection Instrument (TPI)" which requires compliance with EU fiscal rules. Compliance with EU

fiscal rules includes the maintenance of sustainable public debt levels. Thus, in a tightening monetary environment to be eligible for support via the TPI, the Italian government may be forced to curtail the extension of debt-funded subsidies to firms, resulting in a further deterioration in their credit health.

## Credit News

### Debt investors are bracing for trouble, and pushing risky loan prices to extremes

**Dec 22.** An increasing proportion of loans are being priced at higher levels as investors remain wary of increasing risk in the economy. The share of debt trading below 80 cents on the dollar has doubled to 5% since mid-2022. As investors become cautious, companies that run into any difficulties could witness a rapid climb in their borrowing costs, consequently pushing them closer to default. Money managers are driving these price movements as they try to adhere to constraints that restrict them from owning risky loans. (Bloomberg)

### Blue-chip firms ready new year bond blitz before rates rise more

**Dec 23.** Blue chip firms are expected to flood bond markets with issuances in early January in anticipation of further rate hikes and deterioration of economic conditions. It has been forecasted that US-investment grade bond sales may reach USD 40bn in the first week of January, which is more than quadruple the issuances seen in December this year. With expectations of additional rate hikes, geopolitical tensions from the Ukraine war, and China's exit from its zero-covid policy, markets are expected to be highly volatile in 2023. Investment grade issuers wary of potential downgrades in the near term are expected to raise capital early next year. (Bloomberg)

### Turkey finally pushes credit costs below deposit interest rates

**Dec 21.** Turkey's aggressive monetary easing has caused the cost of commercial loans to fall below the cost of deposits for the first time since 2019. As per official data released in December, the cost of commercial loans stands at 14%, one percentage point lower than the cost of one-month deposits. The drop in the cost of commercial loans is driven by a 500bps reduction in interest rates by the Turkish Central bank in 2022 and is also supported by regulations which pushed lenders to extend cheap credit to businesses. Commercial loan costs have continued to fall for 13 consecutive weeks and are now below one-month deposit rates, thrusting banks in a position where their revenue from loans is not sufficient to cover the cost of deposits. (Bloomberg)

### Massive government borrowing looms over European markets

**Dec 23.** As ECB is cutting its bond holdings, the European governments, led by Germany, also decide to issue more bonds to borrow money, which will lead to a bond market flooded with issuances. Investors will need to absorb the additional bonds of EUR 600bn next year. Most investors and analysts don't think the current situation could constitute a full-blown debt crisis in Eurozone, yet the governments are indeed faced with soaring borrowing costs and more market volatility. The most indebted countries in the Eurozone, such as Italy and Spain, still draw a lot of attention with their government bond yield spreads surging over the German equivalent. (WSJ)

### Top Indian banks vie for no. 1 bond spot as credit demand surges

**Dec 22.** Strong credit growth has sparked an intense competition amongst India's largest rupee-denominated bond arrangers. Even in a high interest rate environment, Indian businesses have continued to borrow as operational costs increase. Consequently, corporate bond sales have surged driven by record issuance from banks as they strengthen capital buffers and increase lending. Although growth in India remains under pressure, the economy registered an expansion of 6.3% in the latest quarter, pointing to the resilience in the economy. As per central bank data, commercial lending growth at banks touched a decade high in Oct-2022. (Bloomberg)

**Nippon Life weighs more Japan bond purchases as BOJ lifts yields** (Bloomberg)

**BNP Paribas faces tougher capital requirements** (FT)

**Credit-market rebound leaves Korea's weaker firms lagging behind** (Bloomberg)

**Regulatory Updates**

**Bank of Japan stuns markets with yield control policy change**

**Dec 21.** The Bank of Japan's decision to tweak its yield control policy caught currency, bond, and equity markets by surprise as traders saw the change as a hawkish pivot. As a result, the yen appreciated higher than 4% against the dollar and Japan's 10-year government bond yield jumped to a high of 0.47%. However, the BoJ governor Kuroda stressed that the move doesn't constitute a hawkish pivot and that the central bank does not intend to get rid of its yield target. (FT)

**Leading ECB policymaker hints at sharp climb to peak rates**

**Dec 26.** Klaas Knot, a key ECB policymaker recently reiterated that the ECB may undertake multiple rate hikes in the 5 policy meetings scheduled till Jul-2023. With the eurozone CPI registering a record high of 10.6% in Oct-2022 and remaining well above ECB's 2% target, Knot believes that ECB is only halfway through its tightening cycle. However, with growth showing signs of slowing down, the central bankers are set to face a fine balancing act between controlling inflation and avoiding a growth slowdown. (FT)

**Cryptocurrencies could cause the next financial crisis, Indian central bank head warns** (CNBC)

**Fed's inflation fight becomes trickier as cost of services climbs** (FT)

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