



Rising funding costs and recessionary headwinds worsen the credit risk outlook of Eurozone banks

by [Amrita Parab](#)

- **NUS-CRI PD suggests that despite profitability tailwinds, EU banks exhibit an increase in credit risk driven by worsening macroeconomic conditions and increasing funding costs**
- **NUS-CRI Forward PD indicates that the credit risk outlook of EU banks deteriorates as economic slowdown threatens asset quality**

Banks domiciled in the Eurozone have been witnessing an increase in their credit risk since the beginning of last year, as measured by the NUS-CRI 1-year Aggregate (median) Probability of Default (Agg PD) in Figure 1a. A rise in geopolitical tensions due to the Russia-Ukraine war, and the resultant impact on energy prices throughout the second half of last year contributed to the European central bank (ECB) raising rates to contain the rapidly rising inflation, which reached a high of [10.6%](#) in Oct-2022. Despite the positive impact of the rate hikes on bank profitability, the worsening macroeconomic environment as well as global markets' risk-off sentiment due to the increasing possibility of a recession drove the credit risk of the banking sector higher, widening the gap between the most and least vulnerable members of the industry. Looking forward, the Eurozone banking industry is poised to face further headwinds as monetary tightening by the ECB negatively impacts funding and liquidity, and a looming recession potentially worsens asset quality, as suggested by the NUS-CRI Aggregate (median) Forward 1-year Probability of Default (Forward PD¹) in Figure 1b.

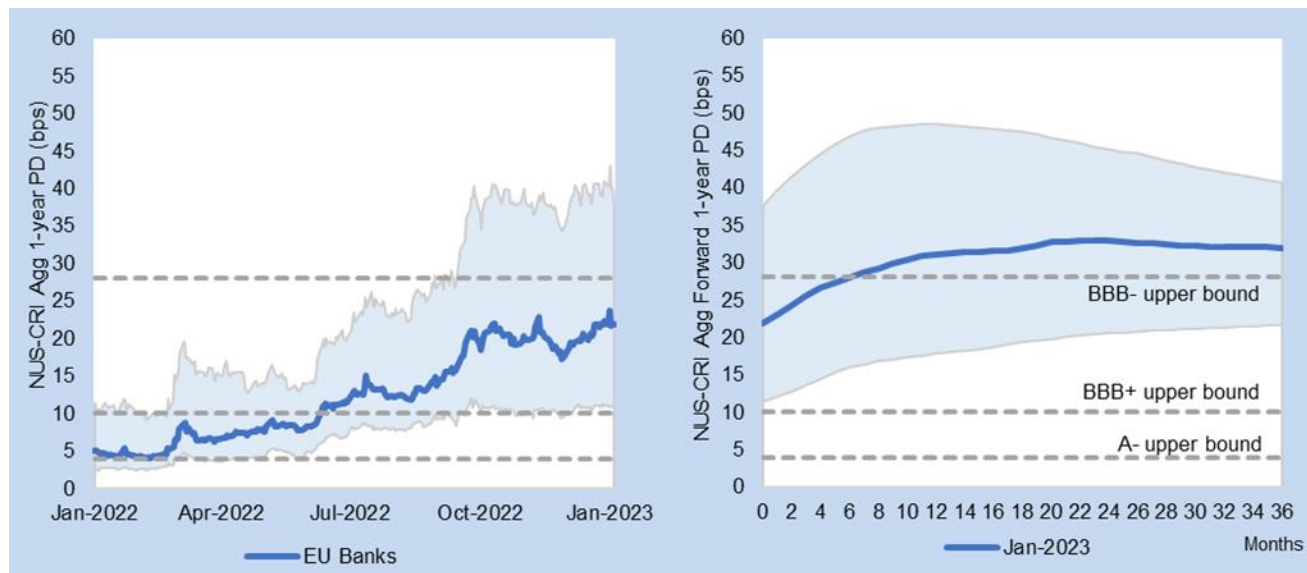


Figure 1a (LHS): NUS-CRI Agg (median) 1-year PD for Eurozone banks with reference to PDiR2.0² bounds and its interquartile range. Figure 1b (RHS): NUS-CRI Agg (median) Forward 1-year PD for Eurozone banks as of Jan-2023, with reference to PDiR2.0 bounds and its interquartile range. *Source: NUS-CRI*

Multiple rate hikes in 2022 saw EU banks register robust [profits](#)³, allowing EU banks to [exit](#) the era of negative rates which had weighed on profitability for almost a decade. As the ECB remains determined to undertake [multiple](#) rate hikes in 2023, the banks' net interest margins are expected to remain robust. However, growing

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 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.

³ In addition to higher profits from the traditional lending segment, the banks also took advantage of the heightened market volatility to [boost trading revenue](#).

macroeconomic issues threaten to eclipse the continued boost in the banking industry's overall profitability. As EU governments battle inflation through a rate-hike-induced economic slowdown, excessive profits in industries, such as banking and energy, are rapidly coming under scrutiny possibly through the imposition of [windfall taxes](#)⁴.

Furthermore, although the corporate demand for loans has remained resilient, most corporates are borrowing to meet higher working capital requirements as [opposed](#) to fixed investment. On the other hand, the demand for credit from households is already showing signs of decline with the ECB's Oct-2022 Bank Lending Survey showing a sharp [42%](#) drop in the demand for home loans. Amidst heightened inflation and slowing growth, higher borrowing costs may eventually lead to a drop in credit growth as consumers avoid big-ticket purchases and as corporates postpone expansionary projects. In H2 2022, EU banks have also [tightened](#) credit standards for home loans due to the ongoing cost-of-living crisis as they remain wary of a possible increase in credit risk from loans originating from this segment, further dampening credit growth prospects.

A slowdown in credit growth may squeeze banks' bottom lines as they concurrently face an increase in funding costs. In Oct-2022, the [ECB](#) announced a change in its terms for the targeted longer-term refinancing operations (TLTRO-III) program⁵. As the ECB pivoted on policy to reign in inflation, in Nov-2022, the central bank [raised](#) the TLTRO rate to the prevailing ECB deposit rate ([1.5%](#)) which led to an increase in the funding cost by [200-250 bps](#), prompting banks to repay [EUR 800bn](#) that had been availed under the program. As such, moving forward, banks may have to opt for costlier funding sources as they try to bridge the gap left by central bank funding. Even though in the longer term, banks may be able to bridge the funding gaps by attracting higher deposits from households and corporates, in the shorter term they may have to rely more on costlier sources (See Figure 2a) such as debt market instruments to meet their needs.

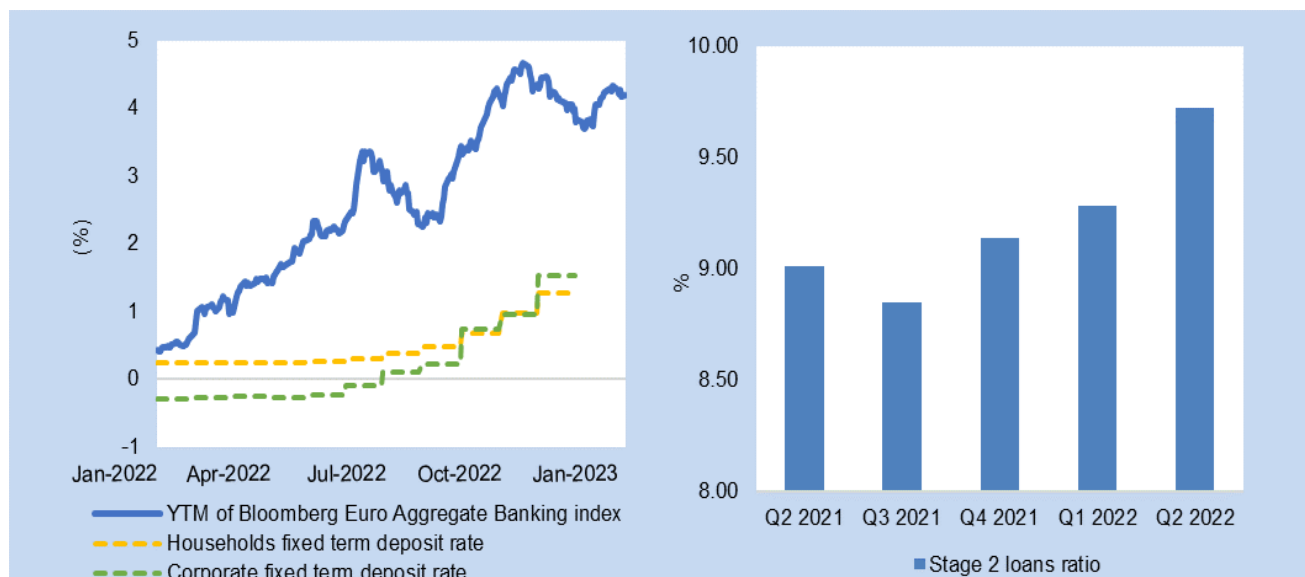


Figure 2a (LHS): Yield to maturity(%) of Bloomberg Euro Aggregate Banking Index; Bank deposit rates for households and corporates with a fixed maturity deposit Figure 2b (RHS): Stage 2 loans ratio of EU banks Source: Bloomberg, ECB

Adding to the woes, as the macroeconomic condition deteriorates, the asset quality of outstanding loans may also be prone to [deterioration](#). Higher refinancing costs amidst a tough operating environment may hamper the debt serviceability of companies leading to higher NPLs. Similarly, with the cost-of-living crisis already eroding household disposable income, going ahead if inflation does not abate, there may be a rise in delinquencies arising from household mortgages⁶. The surge in mortgage rates has led to a demand decline in home loans which has resultantly caused a subsequent decline in home prices (for example, the current housing market crash in [Sweden](#)). The decline in the values of the underlying collateral and an expected increase in delinquency are pushing banks to set aside higher [loan loss provisions](#). The surge of Stage 2 loans⁷ as a percentage of banks' loan portfolios to [9.5%](#) in Q2 2022 serves as a warning sign by regulators which foretells further

⁴ In Dec-2022, Spain became one of the first major economies to impose a windfall tax on its domestic banks. Should the cost of living crisis persist, more EU nations, especially highly indebted nations such as Italy, are expected to impose similar windfall taxes which may restrict banks' profitability.

⁵ The program allowed banks to avail cheap credit from the ECB and allowed banks to facilitate credit extension in a pandemic-ridden economy.

⁶ Home loans make up around [30-50%](#) of EU banks' customer loans and are collateralized by the underlying residential property.

⁷ A [Stage 2](#) loan refers to a loan which has witnessed a substantial deterioration in credit quality since it was first recognised.

deterioration in asset quality (See Figure 2b). A potential silver lining is that EU banks have robust capital positions⁸ which provide a buffer against any severe economic downturns.

In the coming year, with multiple rate hikes around the corner, lending growth is expected to contract as demand for loans declines. Banks have already begun [tightening](#) lending criteria to limit souring assets. However, the banks' existing exposure to vulnerable sectors may deteriorate banks' asset quality. As of Q2-2022, EU banks have already registered a higher jump in Stage 2 loans in the [construction and automobile sectors](#), a trend which may worsen should fears of a recession materialize. EU regulators have also [stepped up](#) scrutiny to monitor banks' credit risk management processes through timely recognition of impaired assets, while also monitoring banks' ability to navigate the increase in funding costs. Therefore, robust balance sheets, conservative lending standards, and higher regulatory scrutiny may potentially prevent a sharp deterioration in credit health in face of a recession, as suggested by the Forward PD in Fig 1b.

⁸ EU banks CET 1 ratio stands at 14.96% as of Q2 2022. Source: ECB

Credit News**Companies rush to tap US bond market as credit conditions ease**

Jan 07. A large amount of company issuance come to the bond market in the first week of 2023, following the expectation of the Fed's slowing tightening scheme. Although the Fed has shown resolution for rate hikes until the inflation rate declines to 2%, Treasury yields and especially corporate debt yields have fallen as investors believe the Fed's target can be reached in the middle of the year and the economy will also be in better shape than previously anticipated. The corporate yield spread has been shrinking since Oct. 2022, indicating an expectation of a lower risk of default. However, some investors remain cautious about the credit market and are quite selective when it comes to bond buying. ([FT](#))

Green bonds are set to drive corporate ESG debt out of slump in 2023

Jan 06. Corporate ESG bond issuances and sales are set to recover in 2023 fueled by strong demand and a large number of green projects in need of funding. The popularity of ESG bonds came to its first halt in 2022, with its issuance falling 22% to USD 362bn. However, analysts believe that the ESG market will rebound to levels seen in 2021 this year, mainly driven by green bonds and some new types of instruments such as SLBs. Green bonds may be the cheaper credit available to companies and dominate the ESG issuances in the bond market. ([Reuters](#))

US junk loan investors brace for increase in downgrades and defaults

Jan 03. The US junk loan market is expected to contract as its biggest buyers plan to cut their holdings for there are significant rises in rating downgrades and defaults. CLOs, the two-third market owner of America's low-grade corporate loans, though have taken great advantages during pandemic-easing, may be forced to shrink their portfolio exposure to meet the risk limits stated in the covenants. The rising interest costs and possible falling earnings are squeezing the cash flows of CLOs, making the leveraged equity tranches stressed and may lead to more downgrades and defaults. The deteriorating profile also bodes ill for attracting new investors, causing trouble for the issuers to refinance in the market. ([FT](#))

Bonds open 2023 with a rally

Jan 08. US Treasuries have started 2023 with a rally as encouraging inflation data from Europe and smaller than expected increase in average hourly earnings for works signal to investors that central banks are getting a grip on inflation. The US Fed raised rates by 50bps in Dec-2022, slowing down from the regular 75bps hikes seen throughout 2022. Though the bond market saw a reversal in the rising bond yields seen throughout the end of last year, the rally was not close to the one seen at the start of last year. The 10-year yield settled at 3.57% at the end of the first week of Jan-2023, down 30bps week-on-week. The rising treasury yields had a profound impact on many asset classes as well as household mortgage rates for which it is used as a benchmark. However, looking forward, risks still remain as the labor market remains tight. ([WSJ](#))

Global negative-yielding debt wiped out by Japan policy shift

Jan 05. The market value of negative-yielding bonds has dropped to zero for the first time since 2010 after the Bank of Japan (BoJ) shifted policy in Dec-2022. The market for negative-yielding debt grew to above USD 18tn near the end of 2020 due to central banks reducing rates because of the pandemic. However, after policy pivots to rate hikes picked up steam in the latter part of last year to curb inflation, the pile of negative-yielding debt shrank substantially. Japan, which still has rates near minus 0.1 per cent, remained the only bond market with sub-zero yields. However, Japan's policy pivot to raise rates saw yields on Japanese government bonds increase to 0.03 per cent from -0.02 per cent in Dec-2022. Though nominal yields have now buoyed above zero, real yields, due to high inflation, remain negative in many markets. ([FT](#))

Biggest junk-bond ETF draws most cash since 2020 as debt rallies ([Bloomberg](#))

Japanese internet firm Rakuten selling USD 200mn bond ([Bloomberg](#))

Sri Lanka's lenders should cancel debt, academics say in letter ([Bloomberg](#))

Regulatory Updates

Global regulators to step up scrutiny of risks outside banking system

Jan 05. Global regulators are set to broaden their focus to the “non-bank financial institutions”, including hedge funds, clearing house and pension assets etc. The reasons for this shift could be traced back to the financial crisis in 2008, after which watchdogs tightened regulations on banking system yet causing a dispersion of risks to other financial institutions. The liquidity crunches started from “dash for cash” of hedge funds to the failing investment strategies of pension funds triggered the needs for regulators’ NBFIs awakening. The NBFIs pose challenges to the regulators with diverse risk profiles and asset structures. To better handle the NBFIs market, regulators may need global co-ordination and tailored instruments for different entities in the financial system. ([FT](#))

Beijing blocks listings of ‘red light’ companies to steer funding to strategic sectors

Jan 09. China's regulator (CSRC) has blocked certain companies from listing in its exchange to prioritize equity funding of its strategic industries. CSRC has told some bankers that several industries (including food and beverage, alcohol makers, education businesses etc.) are given a 'red light' status that makes them off-limits to equity financing. There are also companies and industries given a 'yellow light' status where their listing could come under heavy scrutiny should they be heavily reliant on debt for growth. This phenomenon underscores the government's efforts towards creating a stock market that is in line with industry policy, rather than one which is dominated by market forces. As such, companies that are in line with the country's industrial strategy may be prioritized for listing despite having worse financial performance than ‘red-light’ counterparts. ([FT](#))

FTX's US and Bahamas bankruptcy teams make peace in rival cases ([FT](#))

China central bank to support private firms, ease tech crackdown ([Reuters](#))

Published weekly by [Credit Research Initiative – NUS](#) | [Disclaimer](#)
Contributing Editors: [Raghav Mathur](#), [Wang Anyi](#)

