



Italian banks' credit risk set to swell over fears of potential sovereign debt crisis resurgence

by [Elaine Uy](#)

- **NUS-CRI Agg 1-year (median) PD reflects the impact of increasing domestic sovereign risk on Italian banks, signifying their correlation owing to substantial government debt holdings**
- **Stress test using BuDA suggests that the rising rates environment could worsen the credit quality of vulnerable Italian banks as local corporates face heightened credit risk on the back of the rising cost of financing**

The ECB is set to start [hiking interest rates](#) in Jul-2022 after [winding up](#) its longstanding Asset Purchase Programme (APP), which was introduced in support of EU member states hit by the 2011 sovereign debt crisis¹. As one of the hardest-hit member states during the crisis, Italy was one of the main benefactors of the APP and has the [highest](#) debt level² in the region as of Dec-2021, and thus will likely be affected by the withdrawal of favorable ECB policies. A substantial portion of these government debts is held by Italian banks, exposing them to sovereign risk. For most of 2021, NUS-CRI Aggregate 1-year (median) Probability of Default (Agg PD) for Italian banks has been hovering steadily within the A- Upper Bound range when referenced to PDiR2.0 bounds (See Figure 1a). However, the [supply chain disruptions](#) caused by the Russia-Ukraine war³ triggered the uptrend in the Italian banks' credit risk. For highly leveraged EU member states like Italy, the impending monetary policy tightening in response to soaring inflation could potentially result in an increase in overall credit risk and NPLs for Italian corporates. In such an unfavorable economic environment, Italian banks' median credit health may be expected to further deteriorate and marginally advance towards the upper quartile as shown in the NUS-CRI Agg (median) Forward 1-year PD (Forward PD⁴) (See Figure 1b).

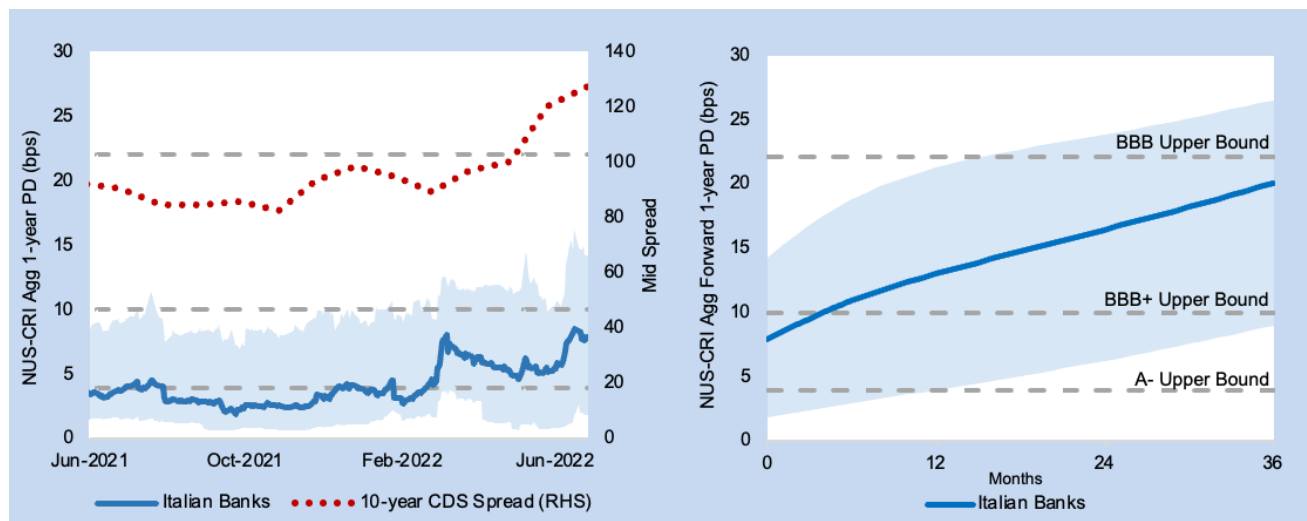


Figure 1a (LHS): NUS-CRI Agg (median) 1-year PD for Italian banks from Jun-2021 to Jun-2022 with the 25th and 75th percentiles of the Italian banking industry, with reference to PDiR2.0 bounds⁵; Italian 10-year Sovereign Credit Default Swap (CDS) Mid Spread from Jun-2021 to Jun-2022. Figure 1b (RHS): NUS-CRI Agg (median) Forward 1-year PD for Italian banks as of Jun-2022 with the 25th and 75th percentiles of the Italian banking industry, with reference to PDiR2.0 bounds. *Source: NUS-CRI, Refinitiv*

¹ The EU debt crisis was set off by the member states' (Portugal, Ireland, Italy, Greece, and Spain) high levels of public debt.

² Italian government debt is at [150.8%](#) of its gross domestic product (GDP) as of Apr-2022, surging recently because of the [pandemic](#).

³ Among EU member states, Italian banks have the [highest exposure](#) to businesses directly affected by the Russia-Ukraine war.

⁴ 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.

⁵ 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.

Yields on Italian sovereign bonds across all tenors⁶ have [shifted upwards](#) in 2022 compared to 2021 levels, and the rising borrowing costs were realized in the country’s [most recent debt issuance](#), triggering speculations that the credit risk associated with the Italian government might have increased, as demonstrated by the recent uptick in the country’s 10-year CDS spread (See Figure 1a). Italian banks, which collectively hold around [38.1%](#) of domestic sovereign bonds as of Mar-2022⁷, will likely feel the impact of the increased sovereign risk through the elevated capital charge⁸ required to buffer potential losses. Nonetheless, as of Dec-2021, the industry’s average Common Equity Tier 1 ratio of [15.3%](#) is well above the regulatory requirements and should provide an adequate buffer against additional potential losses.

Government aid and moratoria have contributed to the reduction of Italian banks’ non-performing loans (NPL) to around [0.92%](#) of the total loan portfolio. As these expired in Jun-2022, Italian banks may see an uptick in NPLs going forward. In the face of surging inflation⁹, which enhances the case for aggressive monetary tightening, Italian banks’ asset quality might further deteriorate as businesses’ repayment capacity is strained owing to higher operating and borrowing costs¹⁰. Moreover, the [increasing share](#) of the government’s ongoing public guarantees on the Italian banks’ balance sheets further increases the industry’s exposure to sovereign risk. The correlation between the sovereign and banking industry’s credit risk has already invoked [caution](#) from the market, pushing stock valuations down and making it costly for Italian banks to issue equity in lieu of debt, amid high borrowing costs, should they require additional financing.

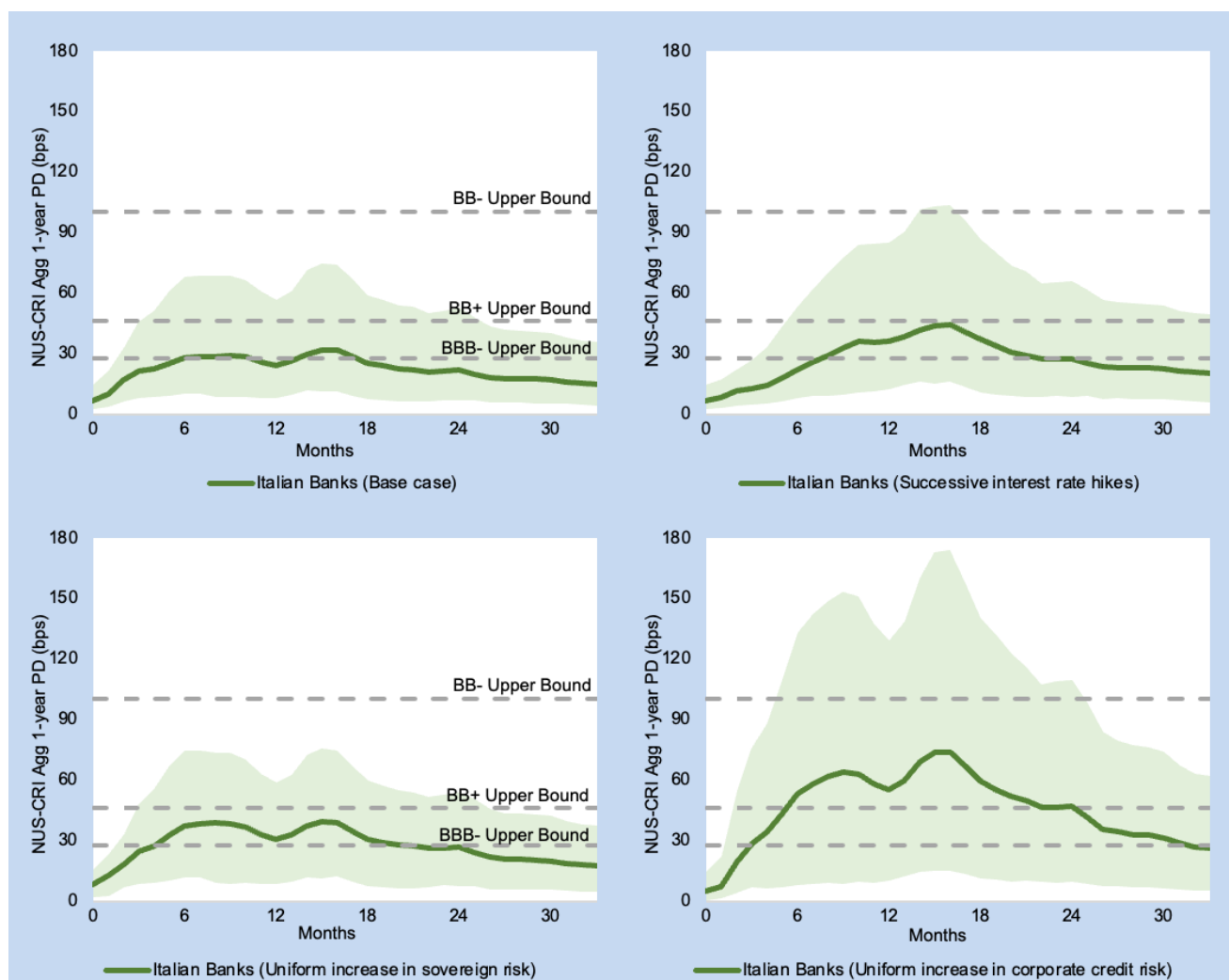


Figure 2a (Top Left): Stressed NUS-CRI Agg (median) 1-year PD of Italian banks based on historical 10-year sovereign CDS mid spreads, and corporate credit risk cycle indices (CCI) from 2011-2013, adjusted for the imminent increase in interest rates by the ECB (base case) with the 25th and 75th percentiles of the Italian banking industry, with reference to PDiR2.0 bounds. Figure 2b (Top Right): Stressed NUS-CRI Agg (median) 1-year PD of Italian banks based on successive quarterly 25bps rate hikes while holding other variables constant. Figure 2c (Bottom Left): Stressed NUS-CRI Agg (median) 1-year PD of Italian banks based on a uniform 50% increase in monthly CDS spreads

⁶ The 10-year government bond yields reached an 8-year high of 4.17% in Jun-2022.
⁷ Domestic government bond holdings decreased by 9.9% from its 48% peak in 2014 because of post-crisis prudential initiatives, such as portfolio restructuring, to reduce exposure to sovereign risk.
⁸ Capital is expected to be affected by approximately [20 to 25bps](#).
⁹ EU’s inflation recently hit a [new record](#) in anticipation of energy price increases following Russia’s [reduction of gas exports](#).
¹⁰ Lending rates have been generally [increasing](#) since Jan-2022, especially for long-term loans.

while holding other variables constant. Figure 2d (Bottom Right): Stressed NUS-CRI Agg (median) 1-year PD of Italian banks based on 50% uniform increase in CCI, representing the potential adverse effects of an economic slowdown, while holding other variables constant. *Source: Refinitiv, NUS-CRI, BuDA v3.3.0*

Using the NUS-CRI Bottom Up Default Analysis toolkit's (BuDA) stress scenarios to simulate the occurrence of a similar debt crisis as 2011 and measure its effect on Italian banks, stressed PD for the most vulnerable banks in the industry is seen to rise rapidly over the BB+ upper bound in the short to medium term in response to the shock before converging towards the median (Figure 2a). Despite the sharp increase in the short term, Italian banks exhibit a lesser vulnerability to adverse economic conditions like that seen in 2011, in general, with the resulting stressed median PD (base case) remaining significantly lower than the peak of 55bps as seen in the previous crisis. Nonetheless, each of the variables in isolation is analyzed to determine its impact on the Italian banks' PD. As shown in Figure 2b, successive interest rate hikes would flex the trajectory of the stressed PD of the vulnerable banks upwards as the high-interest environment impedes loan portfolio growth while concurrently increasing their cost of funding. Additionally, with the ECB [actively instituting measures](#) against taking advantage of rising interest rates, the Italian banks' earning potential could remain capped, hindering the resultant growth in NIMs. In comparison, the worsened credit profiles of Italian corporates, which could signify operating and financing difficulties affecting their repayment capacity due to higher borrowing costs, results in a steeper rise in Italian banks' stressed PD (See Figure 2d). This suggests that an increase in the credit risk of Italian corporates may weaken the asset quality for Italian banks, especially for the vulnerable banks considering their likely weaker fundamentals. On the other hand, while the most and least vulnerable Italian banks appear to be indifferent to an increase in the perceived level of sovereign risk when compared to the base case (See Figure 2c), the upward shift in the median PD emphasizes the overall increase in the industry's credit risk. Such movement is potentially reflective of the substantial sovereign exposure of most banks in the industry who haven't yet completed their government debt offloading.

Going forward, the deterioration of Italian banks' credit health might be dependent on the realization of the expected unfavorable impact of monetary tightening on the Italian economy. Even the ECB recognizes the possible whiplash of aggressive rate hikes to weaker economies, and has committed to instituting preventive and supportive [measures](#). Notwithstanding, a comparison of the Italian banks' Forward PD and the resulting stressed PD (base case) suggests that Italian banks appear more resilient, potentially owing to better asset quality and stronger capital position to absorb unexpected losses, as well as the availability of regulatory support.

Credit News

Bond holders look to recession for salvation after vicious half

Jul 03. Treasury holders have faced massive selloffs in H1 2022 as inflationary and recessionary fears continue to grow. Furthermore, the current low liquidity and high volatility conditions of the market have made it more difficult for treasury market investors to navigate the market. Investment analysts speculate that H2 2022 would be relatively more stable, with yields expected to rise and treasury returns to stabilize, although market conditions remain dampened. However, Federal Reserve is expected to continue hiking interest rates as inflationary woes sustain. ([Bloomberg](#))

Banks get burned by risky debt, imperiling buyout activity

Jul 03. Banks and other lending institutions engaged in leveraged buyout activity are expected to sustain losses of USD 1bn as they sell debts at deeper discounts in response to the poor market conditions. Consequently, leveraged buyout activity by private-equity firms has fallen nearly 20% YoY, prompting buyout firms to turn to non-syndicated debt options such as private-credit providers. Currently, newly issued buyout debt is being sold at 94.8 cents on the dollar as compared to 99.2 cents in Jan-2022. ([WSJ](#))

Junk bond investors stung by China look to India, Southeast Asia

Jun 29. Following a debt crisis in the Chinese property developer sector, Asian junk bond investors are turning towards Indian and Southeast Asian high-yield securities, which have fared better than their Asian peers. Asia's junk debt has experienced a loss of 19%, which is much worse than the 11% and 7.2% drop in Indian and Southeast Asian high-yield securities respectively. Analysts also expect China's proportion in the Asian junk bond market to decrease, while better performing, high-quality instruments from India, Southeast Asia, Australia, and North Asia to see an issuance uptick. ([Bloomberg](#))

Fears of recession leave EUR 40bn of European corporate bonds in distress

Jul 02. More than EUR 40bn of European corporate bonds are trading at distressed levels, as compared to EUR 6bn at the end of 2021. The sharp worsening in market sentiment follows expectations that successive rate hikes will hurt the debt serviceability of corporates. Many expect that central banks' moves to tighten monetary policy could push economies towards recession while the inflationary environment will concurrently increase costs for businesses. Resultantly, 8.8% of bonds in the ICE euro-denominated index are now trading at distressed levels as compared to 1.3% at the end of 2021. The demand for high-yield debt has also seen a sharp reduction, indicating that vulnerable businesses may find it difficult to refinance or may have to do so at a higher cost. ([FT](#))

India banking sector health improves as bad loans hit 6-year low

Jun 30. According to the recently published Financial Stability Report, Reserve Bank of India (RBI) noted that gross non-performing assets of India's banking sector were at 5.9% of total loans at the end of Mar-2022, down substantially from its earlier estimate of 9.8% for the same period. Looking forward, the central bank expects the private sector to see a modest return to profitability. Indian banks are well poised to withstand severe stress scenarios without dipping below the minimum capital requirement. ([Bloomberg](#))

Record green financing in Europe is still nowhere near enough ([Bloomberg](#))

China casts giant shadow over emerging nations' chase for debt relief ([FP](#))

World bank's Reinhart sees more debt distress risks ([Bloomberg](#))

Regulatory Updates**ECB to adjust corporate bond holdings to reflect climate risk**

Jul 04. On 4th July, ECB announced its plan to restructure its corporate bond portfolio to favor climate conscious companies. The bank has committed to reinvest upcoming redemptions in bonds of companies with greener operations and a lower carbon footprint. It is estimated that this strategy will lead to redeployment of about EUR 30bn or 10% of ECB's corporate bond portfolio annually. This move by the ECB is its attempt to incorporate environmental considerations into monetary policy as it tries to address issues posed by global warming. ([Bloomberg](#))

Central bank chiefs call end to era of low rates and moderate inflation

Jun 30. Central bankers all over the world have been stressing the importance of raising interest rates in a timely fashion in order to avoid persistent inflation. At ECB's annual conference, Christine Lagarde, Jay Powell and Andrew Bailey all supported taking swift measures to tame inflation. They reiterated that failing to do so would result in inflation being embedded in the economy which may force central banks to take more severe actions to counteract it. Central bankers from Portugal also shared the same sentiment as they emphasized that geopolitical shocks in the form of the Ukraine war and the covid pandemic have undone factors which supported ultra-low inflation in developed economies. ([FT](#))

Nordic central banks join the 50bps rate hike club ([Reuters](#))**ECB to discuss blocking banks from multibillion-euro windfall as rates rise ([FT](#))**

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