A challenging macroeconomic environment amidst declining credit growth worsens the credit outlook of Italian banks

by Amrita Parab

- **NUS-CRI Agg PD of Italian banks shows a pressured credit risk profile due to declining loan growth and rising funding costs**
- **NUS-CRI Agg Forward PD suggests that a slowing economy amidst higher borrowing costs may threaten asset quality and have an adverse impact on profitability**

Interest rate hikes have resulted in record profits for the Italian banking sector in recent quarters. However, worsening macroeconomic conditions amidst declining credit growth and high inflation threaten the stability of Italian banks' performance moving forward. As seen in Figure 1a, over the course of 2023, the NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) for Italian banks has moved into the non-investment grade territory according to PDiR2.0 bounds[1] on the back of challenging growth prospects and market sentiment regarding the windfall tax proposed by the Italian government. The NUS-CRI Aggregate (median) Forward 1-year Probability of Default (Forward PD[2]) in Figure 1b suggests that Italian banks may see their credit risk increase further as higher interest rates and declining deposit bases point to higher funding costs moving forward. At the same time, weakness in the Italian economy coupled with persistently high borrowing costs may translate into an uptick in non-performing assets as businesses may experience higher repayment pressures over the next twelve months.

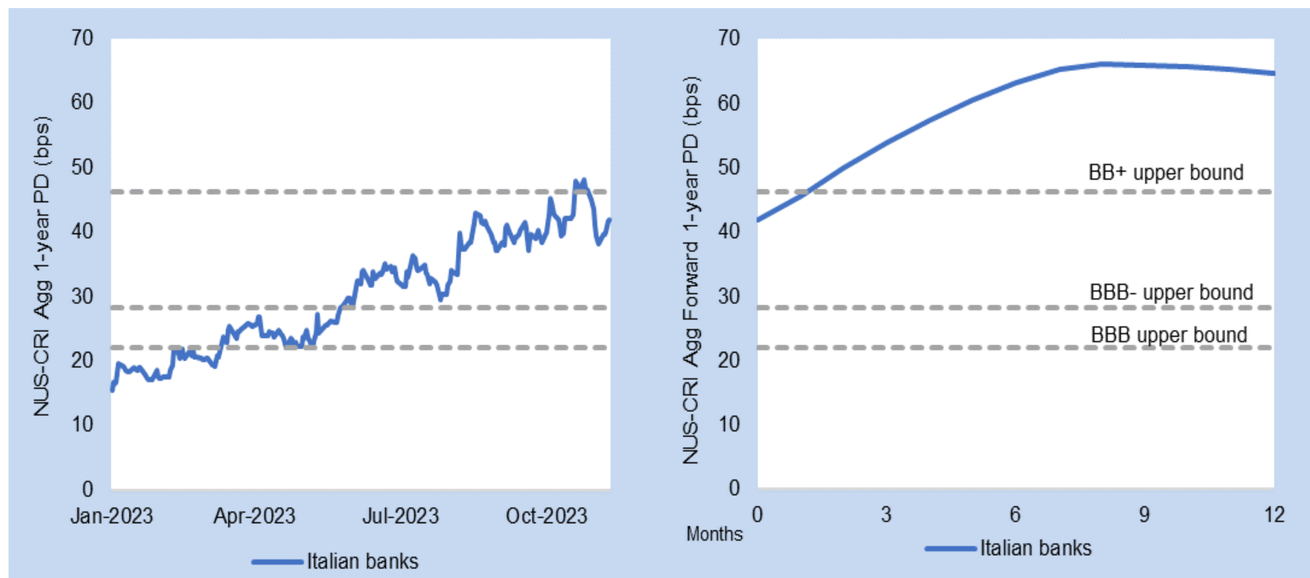

Figure 1a (LHS): NUS-CRI Aggregate (median) 1-year Probability of Default for Italian banks, with reference to PDiR2.0 bounds. Figure 1b (RHS): NUS-CRI Aggregate (median) Forward 1-year Probability of Default for Italian banks, with reference to PDiR2.0 bounds. *Source: NUS-CRI*

The impact of the aggressive monetary tightening pursued by the European Central Bank (ECB) is now becoming evident as the Italian economy has begun to show signs of a slowdown. Italy's GDP growth in Q3 2023 stalled after a 0.4% QoQ contraction in Q2 2023. Lending growth at Italian banks also weakened with higher borrowing costs being a major deterrent for businesses looking to raise capital. Bank of Italy data showed that Italian banks' loans to businesses fell further to record lows in September by 6.7% (See Figure 2a). Similarly,

[1] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation by 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.
[2] 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 18 months, conditional on the firm's survival in the next 6 months.

weakness has also crept into loans extended to domestic households as demand for credit declines following sharp increases in mortgage rates. The rising interest rates have also added pressure on banks' funding position. Resident deposits which form a major funding source for banks have been on the decline exhibiting a 3.5% YoY fall in Sep-2023, lured away by attractive returns offered by alternative investment products. Although the recent drop in lending may have been offset by wider net interest margins, an exodus of retail deposits necessitates an increase in deposit rates and an increase in issuances from more expensive funding sources, which in conjunction with a continued decline in credit growth is likely to adversely impact bank profitability. To meet the funding gap left by the fall in deposits, Italian banks relied on bond issuances which ticked up by 18.4% YoY in Sep-2023 (See Figure 2b). With the banking system closely connected to sovereign credit health, rising Italian government bond yields also indicate that the cost of financing through debt markets remains high for Italian banks, weighing on the sub-sector's serviceability and profitability.

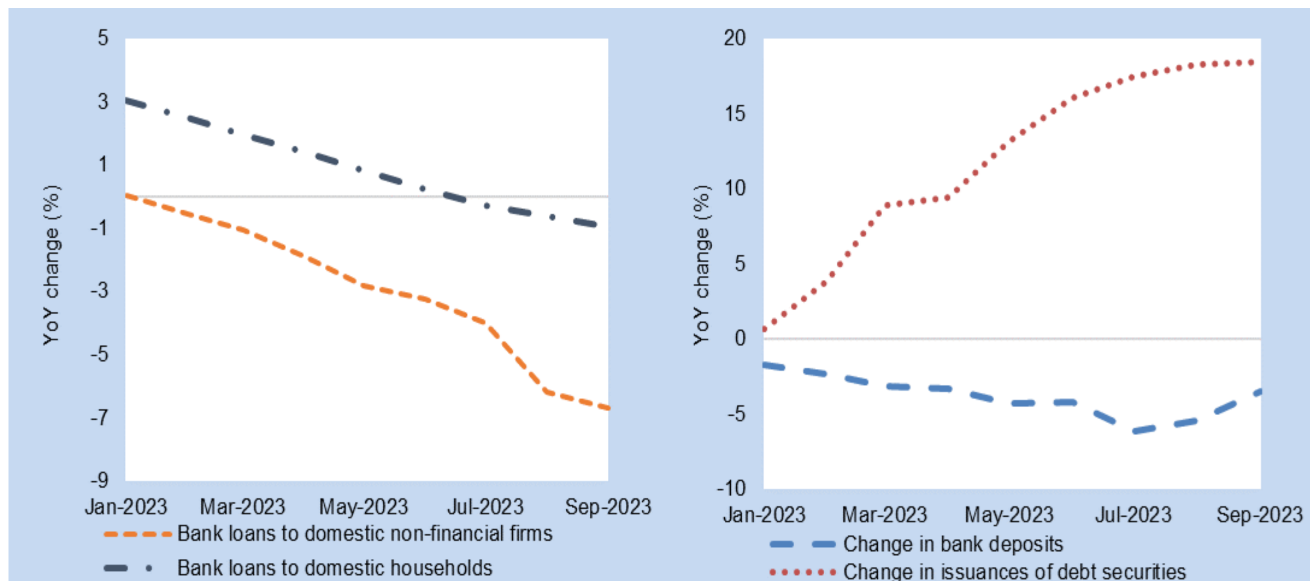

Figure 2a (LHS): Italian banks YoY change in bank loans to domestic non-financial corporations and households (%) Figure 2b (RHS): Change in bank deposits and change in issuance of debt securities of Italian banks (%) *Source: Bank of Italy*

Looking at fundamentals, Italian banks have managed to stay resilient, aided by record profits, robust capital buffers and lower non-performing loan exposure. The ECB's rate hikes helped banks realize higher profits as costs remained in control due to a comparatively slower repricing of deposit rates. Italian banks saw a 77% YoY surge in profit as of Q3 2023. The sub-sector's capital position also remained stable with the CET 1 ratio at 15.3%. Italian banks' asset quality has also remained steady over the past year. Since 2016, Italian banks have been able to substantially reduce non-performing loans with the aid of GACS, a government scheme which allows banks to offload bad loans and clean up their balance sheets through state guarantee. Resultantly, the banks' average NPA ratio stands at 3.2% as of Q3 2023. However, with the economy expected to slow further over the next few quarters, repayment pressures may build up and lead to a deterioration in asset quality.

In addition, the Italian government's proposed windfall tax, which would have seen close to a 12% impact on Italian bank earnings, has also lost its steam. The proposed tax, which the ECB warned would disproportionately impact smaller lenders and affect wider financial stability, was set to take 40% of banks' net interest margins (NIMs), hurting bank profitability especially as the spread between deposit rates and loan rates charged by Italian banks remains one of the widest in the Euro area. However, a positive impact of the revised rules on the windfall tax was that banks were allowed to set aside 2.5x of the amount owed to the government in capital reserves. As a result, Italy's biggest banks such as UniCredit and Intesa, have opted to improve their capital base and buff up their balance sheet.[3] This should provide a longer-term buffer to the credit quality of Italian banks, shielding them from structural challenges pertaining to widespread deposit withdrawal in the face of higher-for-longer interest rates. Conversely, large Italian banks are already relatively well capitalized with additional buffers potentially limiting longer-term credit growth potential. For example, Intesa already has EUR 5bn in excess reserves above the CET1 target, whereas UniCredit has EUR 13bn in excess reserves. Increasing reserves further may impact profitability moving forward, especially as credit growth in the region remains stagnant.

Troubles are also brewing for banks' holdings of government securities, especially in the face of a potential downgrade by Moody's on Italy's sovereign rating into non-investment grade. Should Italy's fiscal position

[3] For example, rather than Intesa and UniCredit paying EUR 0.8bn and EUR 0.4bn as tax respectively, the companies have decided to increase their non-distributable capital reserves by EUR 2bn and EUR 1.1bn respectively.

deteriorate and its sovereign ratings get downgraded, the impact on Italian banks' balance sheets is likely to be pronounced. This downgrade may impact Italian banks' asset quality substantially, although the solvency of the bigger banks is likely to remain robust given their strong capital positions. Regardless, the impact on investment income due to the threat of downgrade, in conjunction with potentially worsened balance sheets, poses hurdles to the credit outlook of Italian banks, contributing to the short-term increase in the sector's Forward PD as suggested in Figure 1b.

Credit News

US interest rates add to 'silent debt crisis' in developing countries

Nov 07. The World Bank warns that smaller emerging markets are facing a "silent debt crisis" due to the impact of high US interest rates on their already-fragile finances. Foreign currency emerging market debt has struggled to recover, with 23% of emerging and developing countries experiencing borrowing costs more than 10 percentage points above the US, compared to less than 5% in 2019. Debt interest payments as a share of government revenues are also at their highest since 2010. The tightening monetary policy has been particularly challenging for lower-income countries with high debt levels, exacerbated by the rise in yields shutting off many from international financing, leading to defaults and heightened risk for others. The situation may hinder economic growth and increase the challenge of debt refinancing for countries such as Egypt and Kenya. (FT)

The clearest sign yet that commercial real estate is in trouble

Nov 13. Foreclosures in the high-risk mezzanine loans sector of commercial real estate finance are soaring, indicating deepening turmoil in the property market. A record number of foreclosure notices for such loans have occurred this year, more than double the 2022 total. Mezzanine loans, often considered second mortgages, have higher interest rates and often lead to a quicker path to foreclosure than traditional mortgages. The surge in foreclosures, though small in absolute numbers, provides a more immediate measure of commercial real estate distress compared to mortgage foreclosure rates. These loans, widely used since the 2008 crisis, are now facing defaults, reflecting a new challenge in property finance and providing a clear sign of distress in the sector. (WSJ)

Big banks cook up new way to unload risk

Nov 07. U.S. banks, including JPMorgan Chase and Morgan Stanley, are employing synthetic risk transfers to offload risk and reduce regulatory capital charges amid tightening regulations and rising interest rates. These complex debt instruments are sold to private fund managers, offering banks a less expensive alternative to bearing full capital charges on underlying assets by regulators The deals involve investors paying cash for credit-linked notes or credit derivatives, reducing banks' regulatory capital requirements. Banks, facing increasing capital rules, have turned to this strategy after the Federal Reserve eased its stance on synthetic risk transfers in 2023. Global risk transfers are estimated to reach about USD 200bn this year, up from USD 160bn in 2022. Alternative investment firms, such as Ares Management and Magnetar Capital, are active buyers of these deals, signaling private credit investment managers becoming more prominent. (WSJ)

Investors pull record sums from corporate bond ETFs as lending rates soar

Nov 10. In October, investors withdrew a record USD 9.4bn from corporate bond exchange-traded funds (ETFs) and redirected funds into lower-risk government equivalents, particularly US Treasury funds, as benchmark lending rates reached 16-year highs. The shift in flow is attributed to the expectation that the Federal Reserve would maintain higher interest rates for a more extended period to combat inflation. The US's key lending rate, Sofr, hit 5.3%, the highest since the pre-financial crisis era. Investors, concerned about a potential economic slowdown and widening credit spreads, favored short-term US Treasury bond ETFs yielding 5% or more, reducing exposure to corporate credit risk. High-yield bond ETFs experienced USD 4.8bn in outflows, while investment-grade ETFs lost USD 4.6bn, their largest decline since March 2020. (FT)

Japanese funds buy most US debt in half year, pressuring Yen

Nov 09. Japanese investors increased their purchases of US sovereign bonds to the highest level in six months in September, with funds from Japan buying a net JPY 3.31tn (USD 22bn) of Treasuries. During the same period, they sold debt in most other sovereign markets tracked by the Ministry of Finance. The rise in US 10-year Treasury yields, which increased by 46 basis points in Oct 2023 to finish at 4.57%, made them more attractive to Japanese investors. The widening yield gap between the US and Japan, currently more than 3.5 percentage points, continues to attract Japanese buyers, despite concerns of potential yen

appreciation. The yield differential has contributed to the yen's weakness, reaching a one-year low of 151.72 per dollar on October 31. (Bloomberg)

Swedish property group SBB faces debt demand from US hedge fund (FT)

Vedanta's way out of trouble is more expensive debt (Bloomberg)

Citadel Securities trains sights on eurozone debt market (FT)

Regulatory Updates

Lagarde says sustaining ECB rate at 4% should help on prices

Nov 10. European Central Bank (ECB) President Christine Lagarde stated that maintaining the deposit rate at 4% should be sufficient to curb inflation, but the central bank will reconsider raising borrowing costs if needed. Lagarde expressed confidence in the current monetary settings, emphasizing that sustaining the current level for an extended period would contribute significantly to bringing inflation back to the 2% target. However, she acknowledged that in the event of major shocks, the ECB may need to revisit its approach. Lagarde also cautioned against assuming the recent 2.9% headline inflation as a given, highlighting the need to monitor energy prices, particularly amid potential Middle East conflicts. She also mentioned that a discussion on reinvestments in the pandemic emergency bond purchase program is on the table for ECB officials, signalling potential further tightening. (Bloomberg)

China's central bank vows liquidity for debt-laden regions

Nov 08. China's central bank Governor Pan Gongsheng announced that the People's Bank of China (PBOC) will provide emergency liquidity support to regions with a relatively heavy debt burden when necessary. Pan highlighted that financial regulators have been working to address debt risks at the local level, emphasizing that government debt levels are mid-to-low compared to other nations. He mentioned that provinces facing higher financial risks are developing plans to resolve the issue, utilizing various channels to replenish capital for smaller banks. The announcement reflects China's efforts to manage risks from local government debt without resorting to major bailouts amid a property market slowdown and wider economic challenges. (Bloomberg)

Mexico central bank governor eyes rate cuts, but not before 2024 (Reuters)

Indonesia central bank sees stronger inflation in 2024 as food, energy prices rise (CNA)

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Contributing Editors: Raghav Mathur