EUROPEAN CENTRAL BANK
BANKING SUPERVISION

NPLs in the euro area: progress so far and COVID-19 outlook

19 May 2021

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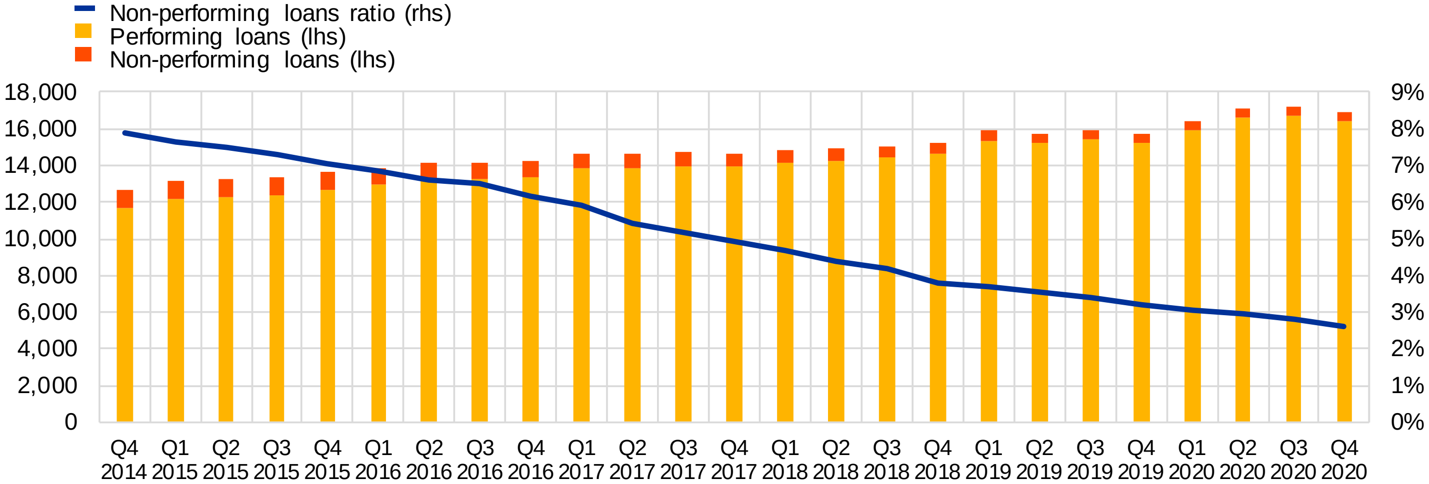
2014-20 NPL developments

- Between the fourth quarters of 2014 and 2020, gross NPLs decreased from €998 billion to €443 billion.
- Despite the pandemic, legacy NPL resolution kept progressing in 2020.
- The pandemic-induced deterioration is not yet visible in the aggregate NPL ratio.

Chart 1
Decreasing NPL trend, uninterrupted in 2020

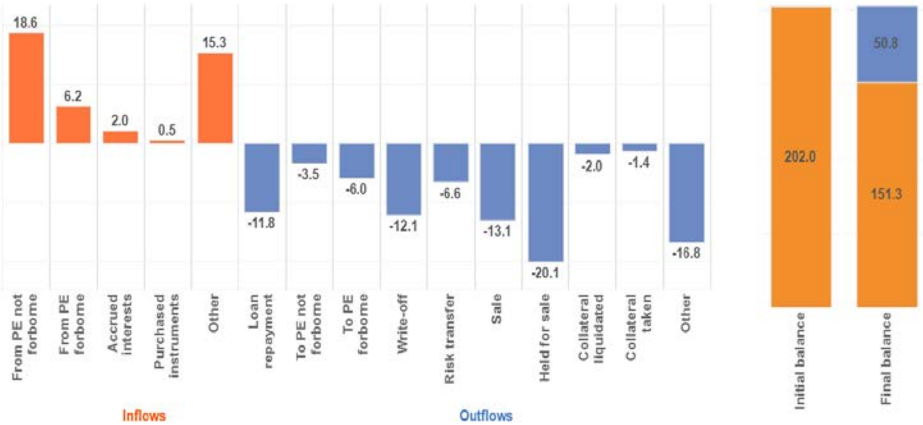


Source: ECB statistics as at the fourth quarter of 2020.
Note: Changing sample.

NPL resolution progress during 2020

Chart 2
High-NPL banks continued to reduce overall NPL positions in 2020, predominantly through sales

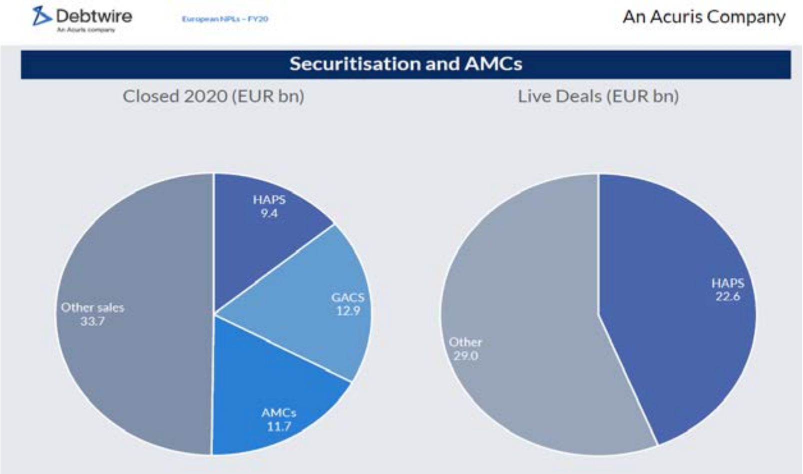
(EUR billion)



Source: ECB.

Notes: ECB Banking Supervision defines “high-NPL banks” as banks with an NPL level that is considerably higher than the EU average.

Chart 3
Publicly supported securitisation schemes and asset management companies are playing an important role



Source: Debtwire.

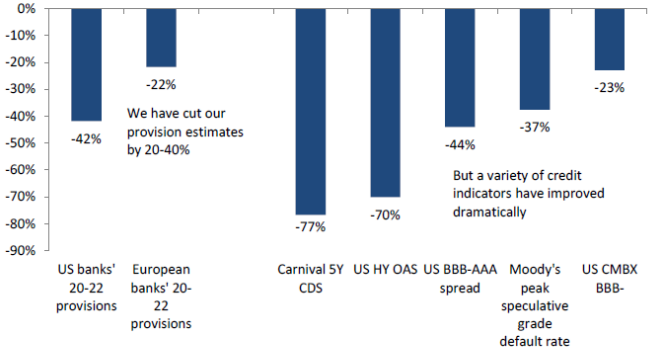
Notes: HAPS stands for Hellenic Asset Protection Scheme; GACS stands for Garanzia Cartolarizzazione Sofferenze.

Markets’ and analysts’ positive outlook

> *“Almost all European banks beat on provisions with their Q1 results, yet most have barely started to reverse last year’s precautionary Stage 1 and Stage 2 reserves.* ***We therefore believe the earnings upgrade potential at European banks from lower provisioning has a long way to run.****”* [Autonomous, May 2021]

Chart 5
Valuations recovered (Euro Stoxx Banks)

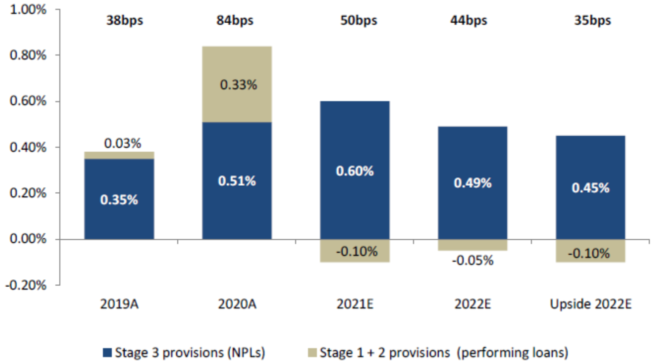
Chart 4
Analysts’ provision estimates decreased in view of positive credit indicators



Sources: Bloomberg, Moody's, Autonomous Research estimates.

Note: Chart shows improvement since the peak of the pandemic in 2020.

Chart 6
Analysts expect release of provisions in 2021-22

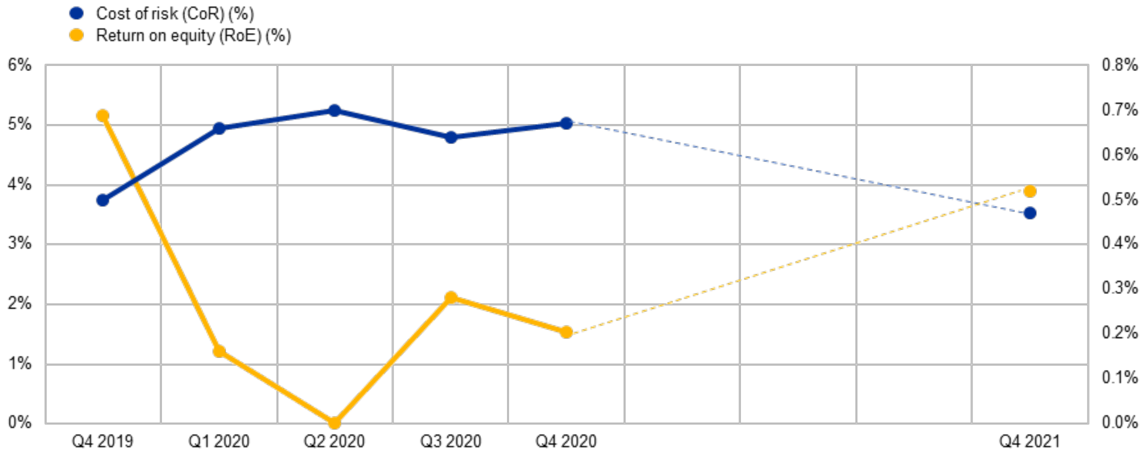


Sources: Company data, Autonomous Research estimates.

Note: Chart shows annual provision charge for European banks.

Banks' projections: profitability pushed up by lower provisions

Chart 7
Banks (significant institutions) project increased profitability and reduced loan loss provisions



Sources: FINREP for actual values, COVID-19 reporting for the projections.

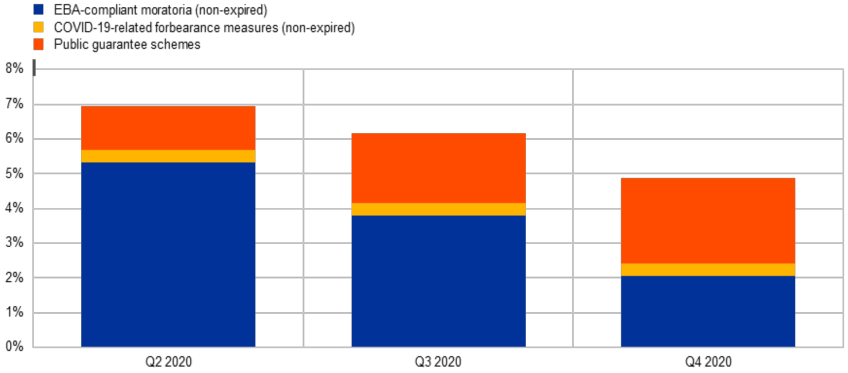
Note: Sample sizes and ratio definitions differ between actual values and projections due to data availability. Cost of risk is the ratio of the adjustments in allowances for estimated loan losses during the relevant period (annualised) divided by the total amount of loans and advances subject to impairment.

- Increasing revenues: fee income to offset contraction in interest income
- Falling loan loss provisions
- Increasing administrative expenses, following 2020 reduction

Areas of supervisory concern: borrower relief measures

Chart 8
Outstanding borrower relief measures are still significant, with public guarantees playing an increasing role

(% of total loans and advances)

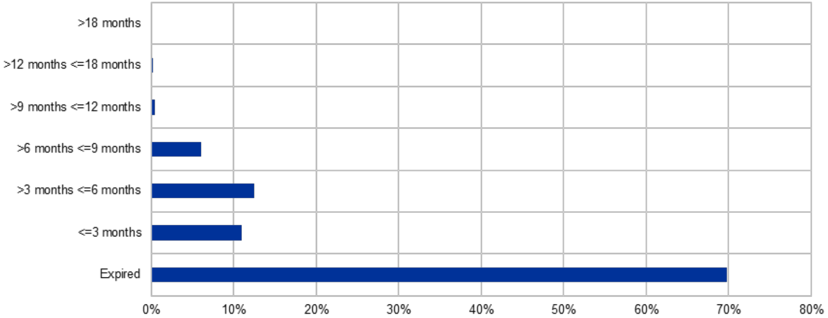


Source: COVID-19 supervisory reporting.

Note: Changing sample.

Chart 9
Most EBA moratoria have expired, the outstanding ones will do so in the course of 2021 (as at Jan 2021)

(% of total EBA-compliant moratoria)



Source: COVID-19 supervisory reporting.

- **Pandemic environment:** borrower support measures affect banks‘ standard credit risk management tools and incentives, warranting in-depth supervisory scrutiny of practices.
- **Potential cliff-edge effects:** if banks are not proactive in managing credit risk, credit losses may be amplified as public support is phased out.
- **Vulnerable sectors(*):** both moratoria and guarantees increased during 2020 within “Food and Accommodation Services”, especially for SMEs, supporting increased lending.

(*) preliminary evidence

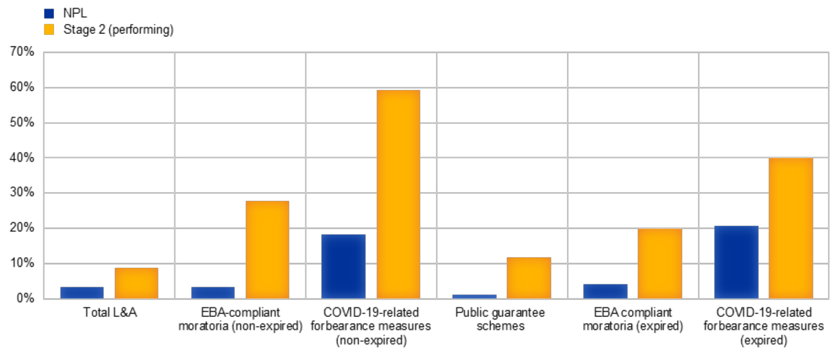
Areas of supervisory concern: asset quality of COVID-19 loans

- **Asset quality:** loans emerging from EBA moratoria and the other COVID-19 forbearance measures have so far performed slightly worse than the overall loan book, while signs of weakening credit quality (Stage 2) are apparent among outstanding measures.
- **Risk shifting:** on publicly guaranteed loans, identified asset quality deterioration and provisions remain lower. From a supervisory perspective it is crucial to understand which risk management incentives are at play.
- **Vulnerable sectors(*):** within “Food and Accommodation Services”, very low incidence of loan modification, low unlikely-to-pay assessments, lower probability of default on new loans. Key to understand interaction with public support and other bank-led support measures.

(*) preliminary evidence

Chart 10: Asset quality by loan category

(% of total category, fourth quarter of 2020)

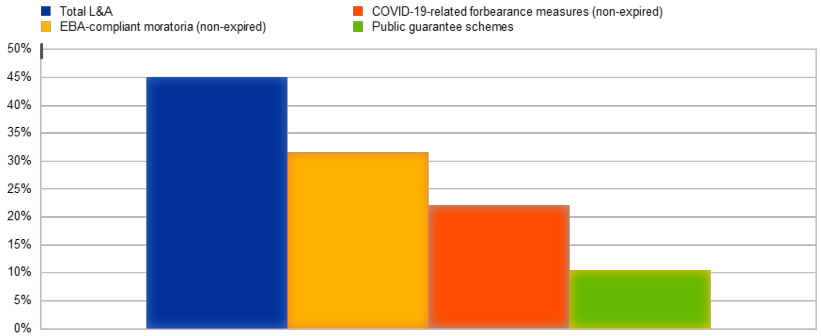


Sources: FINREP and COVID-19 supervisory reporting.

Note: Sample comprises 112 significant institutions.

Chart 11: NPL coverage ratio by loan category

(percentages, fourth quarter of 2020)



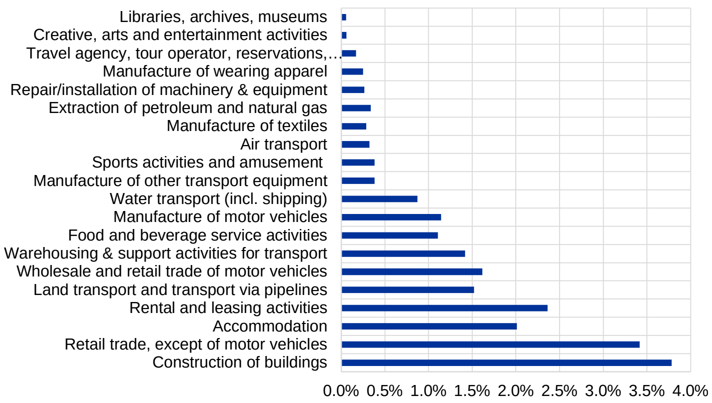
Source: COVID-19 supervisory reporting.

Note: Sample comprises 112 significant institutions.

Areas of supervisory concern: vulnerable sectors

Chart 12
Significant institutions' exposures to vulnerable sectors represent almost 22% of lending to non-financial corporates booked in the euro area

(% of total exposures to non-financial corporates)



Source, lhs chart: AnaCredit data as at the fourth quarter of 2020.

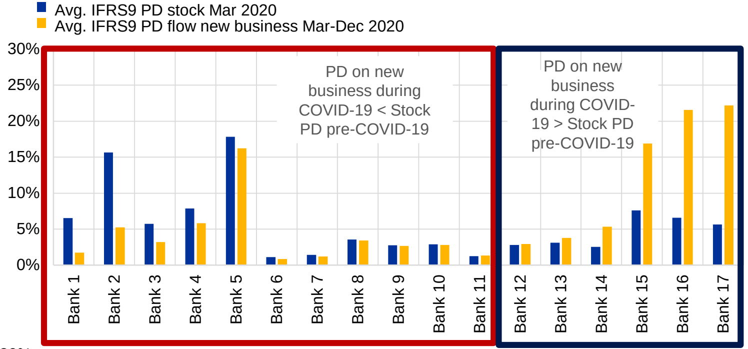
Notes, lhs chart: Sample comprises 106 significant institutions. Exposures granted by subsidiaries outside the euro area are not included in AnaCredit.

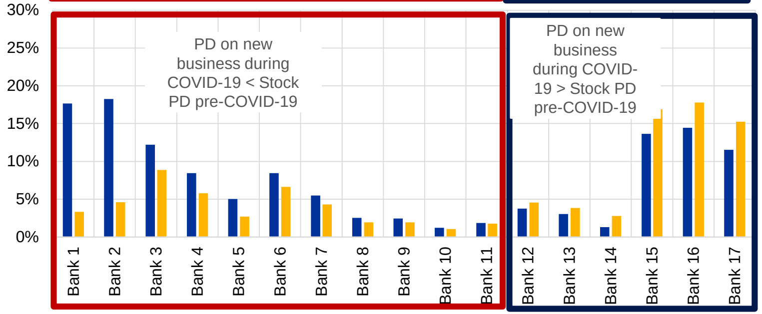
Source, rhs charts: ECB ad hoc data collection.

Note, rhs charts: Preliminary evidence.

Chart 13
Probabilities of default used for provisioning decreased on new lending within accommodation and food

(top chart: accommodation sector, bottom chart: food sector)





Areas of supervisory concern: heterogeneous practices/outcomes

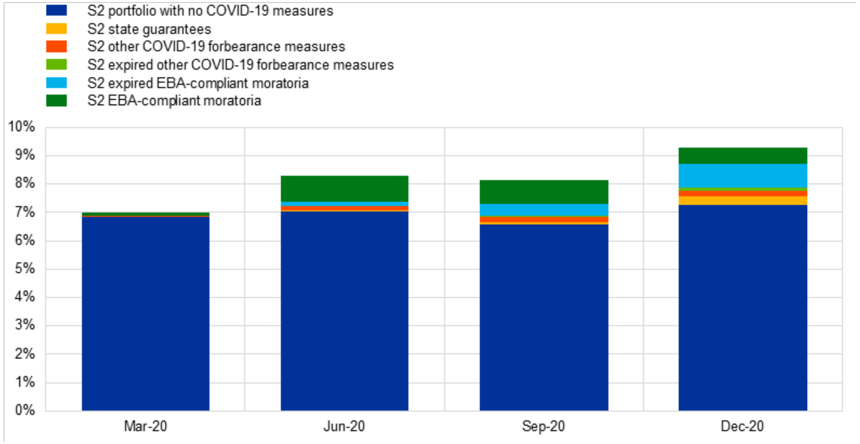
- Growing aggregate incidence of **significant increase in credit risk** (IFRS Stage 2 loans), but wide range of behaviours, including potentially overly optimistic reductions between the second and fourth quarters of 2020.

- Almost half of 2020 **NPL classifications** (IFRS Stage 3 loans) transition directly from Stage 1: operational challenges or result of "wait-and-see" practices?

Chart 14

Stage 2 loans, aggregate evolution

(% of total loans subject to staging, fourth quarter of 2020)



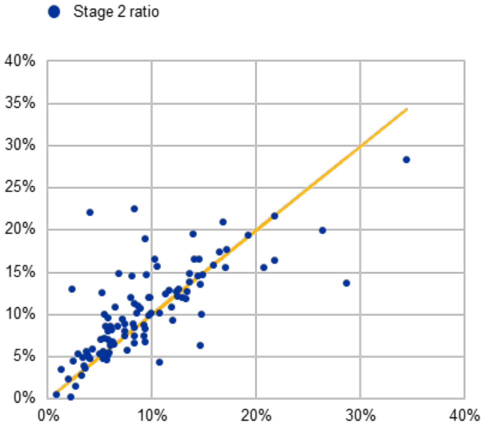
Sources: FINREP and COVID-19 supervisory reporting.

Note: Changing sample.

Chart 15

Stage 2 loans, evolution across banks

(% of total loans subject to staging; x-axis: second quarter of 2020, y-axis: fourth quarter of 2020)



Source: FINREP.

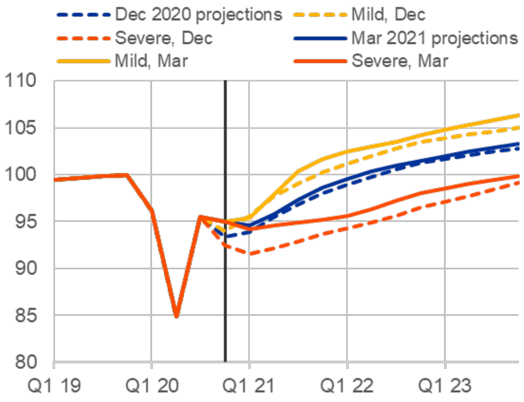
Note: Sample comprises 106 significant institutions.

Macro outlook and bankruptcies: more to come?

- Euro area banks are reducing provisions, but haven’t yet started reversing them like their US peers. In past recessions, euro area banks' provisions started decreasing only just before bankruptcies peaked.

- With macroeconomic forecasts continuously improving, July 2020 NPL scenario based on SSM vulnerability analysis is now outdated. However, an unusual recovery lies ahead. Rather than approaching their peak, bankruptcies have actually fallen throughout the recession.

Chart 16
Macroeconomic forecasts

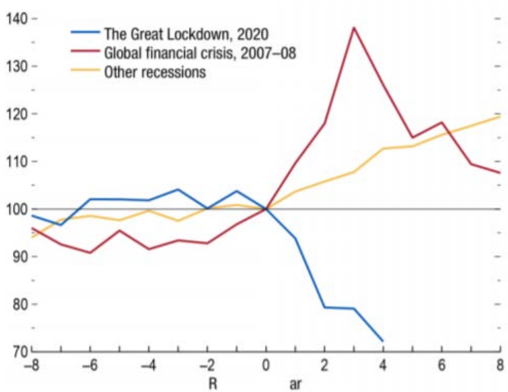


Source: March 2021 ECB and Eurosystem staff macroeconomic projections.

Note: The vertical line marks the start of the projection horizon.

Chart 17
Bankruptcies during recessions

(last pre-recession quarter for each crisis = 100)



Source: IMF World Economic Outlook update (January 2021).

Note: Data from 13 advanced economies, including Canada, France, Germany, Italy, Japan, Spain, United States and United Kingdom.

Conclusions

- The macro outlook has noticeably improved since the start of the pandemic and uncertainty has abated.
- Market momentum turned positive on European banks, which so far have been part of the solution to the challenges raised by the pandemic.
- Supervisory work, however, shows some areas of concern and highlights the need for banks to adhere to rigorous credit risk management standards and factor in the specifics of this unusual crisis.

Thank you for your attention!