

# Focus on: Credits

## 11 January 2023



## European banks: An optimistic outlook for 2023



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In our view, 2023 will see an ongoing trend towards stable credit ratings in the European banking industry. On the one hand, banks should see a continued rise in their net interest income in an environment of further monetary tightening. The last six months of 2022 already provided striking proof that the sector is among the winners in an environment of rising interest rates. On the other hand, having been subject to extensive regulatory reform since the global financial crisis, the industry is well positioned to weather crises, especially thanks to the substantial equity cushions it has built up. Despite this, the business landscape for banks is marked by a number of adverse factors, with the level of non-performing loans set to rise in the foreseeable future. Taken together, therefore, we would advise focusing on issuers with sound credit quality indicators.

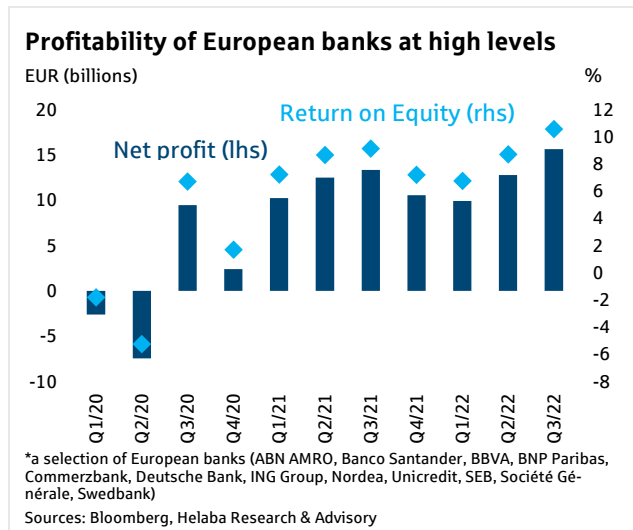
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## 1 Review of 2022: Net interest income grows while asset quality remains stable

When we published our [2022 outlook for European banks](#) a year ago, we chose the title "Spotlight on the interest rate environment". With hindsight, our forecast has proven very accurate: Both **inflation and interest rate hikes by central banks turned out to be the overriding drivers** within the banking industry's operating environment last year. Indeed, **net interest income has been on a rapid upward trajectory** since the middle of 2022 and the sector has managed to fully live up to its reputation as a beneficiary of rising interest rates. Furthermore, as we anticipated, institutions largely avoided the need to utilize provisions for credit risks that they had previously allocated during the COVID-19 crisis. Large-scale government support schemes to protect consumers and corporate borrowers contributed to the fact that NPL ratios remained on a historically low level. In addition, banks returned some of the surplus capital they had accumulated in the wake of the pandemic-hit months, when they suspended dividend payments, to their shareholders in the form of dividends and/or share buybacks.

What we did not foresee, however, was [Russia's invasion of Ukraine](#), which gave a further boost to incipient inflation by driving up energy prices and disrupting supply chains. Although we consider the sector's direct exposure to Russia, Ukraine and Belarus to be relatively limited, the negative impact of the war is primarily of an indirect nature, particularly in terms of the consequences for corporate borrowers.

Overall, **credit quality in the industry** has remained stable. As in the two previous years, banks surprised markets on the upside with solid earnings over the course of 2022. Many market participants had factored in lower earnings for the sector at the beginning of the year. In fact, thanks to rising net interest income and low credit risk charges, banks actually reported improved earnings. That prompted investors and analysts to constantly revise their profit forecasts upwards.



## 2 Outlook for 2023: More positive surprises on the horizon?

### 2.1 Overview - ECB sets the scene

In our view, soaring interest rates will lift **net interest income** and this will **remain a key issue for the sector in 2023**. Our macro analysts expect the current cycle of interest rate hikes to reach its peak this year. On top of that, the ECB is due to start unwinding its inflated balance sheet in March. Inflation and higher interest rates are however simultaneously weighing on both corporates and consumers. For 2023 as a whole, our economists nevertheless forecast a year-on-year increase in gross domestic product of 0.6 % for the euro area, while the German economy is expected to flatline. Though, a recovery could kick in as soon as 2024, with growth in Germany of 1.4 %.

As a result, banks are likely to see a further increase in their net interest income. Despite the fact that **credit defaults are projected to intensify** due to the gloomier macroeconomic outlook, consumers and corporates will be able to fall back on ample savings and capital buffers for the time being. Additionally, the level of **household debt has, by and large, held steady**. That suggests that default rates should remain relatively modest, at least in 2023. However, with persistently high prices and interest rates, risks will increase by 2024 at the latest. This situation will be compounded by rising costs as a result of inflationary pressures. However, we assume that the positives, particularly net interest income, will once again outweigh the negatives. As far as we can gather, [in its blog](#) the ECB banking supervision comes to a similarly upbeat assessment, stating that banks have proven themselves resilient to the effects of rising interest rates in a variety of macroeconomic scenarios.

In general, the **sector is in good shape** and is therefore equipped to cope with any crisis-related pressures. Many banks, especially large ones active on the capital markets, still have excess capital they accumulated during the pandemic as well as additional risk provisioning in the form of management overlays. Compared to the situation when the global financial crisis hit, their capital ratios are around twice as high today and they have also pared back problematic business activities, thereby reducing exposures, and improved their risk management systems. A shift in the interest rate environment could now lead to a resurgence in significantly higher earnings from core activities. Moreover, bondholders are meanwhile protected from defaults by an institutional framework to prevent and manage crises that has been put in place over the last 10 years through a series of regulatory reforms.

As such, senior unsecured bank bondholders have every reason for optimism heading into 2023, all the more so as many of these instruments once again offer attractive yields. Nevertheless, the environment remains extremely volatile and, for that reason, our advice is to **focus on issuers with robust credit quality metrics** and to lean towards medium and short-dated maturities.

## 2.2 Higher margins underpin growth in net interest income

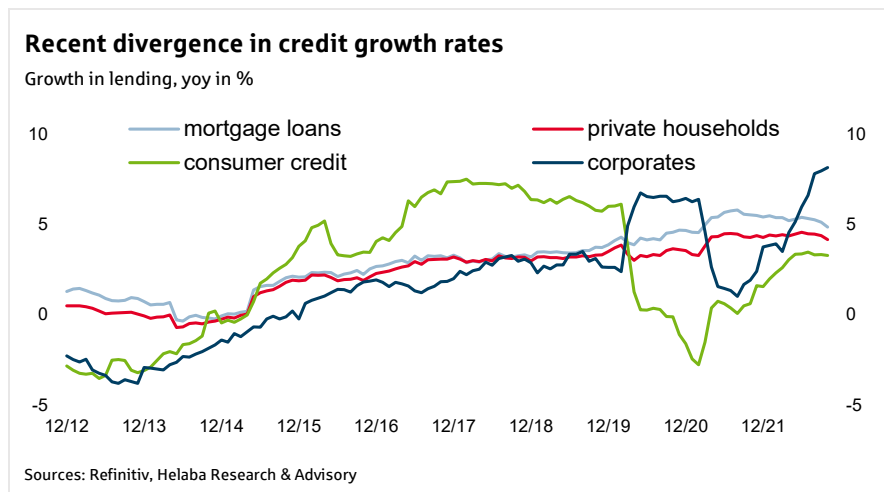
As a general rule, rising interest rates mean that the **trends we have witnessed in recent years** in a negative rate environment will be reversed. With **margins on loans and deposits increasing again**, demand for lending is on the decline and credit defaults are mounting. At the same time, central banks are gradually tapering their quantitative easing (QT) programmes, with the result that structural demand for credit from corporates and the public sector is increasingly being met by banks again. More adequate margins will be supplemented by accelerated growth in lending by the time the recession is over at the latest.

However, let us first address the short-term **prospects for 2023**: Based on our own findings, the unexpectedly strong growth in banks' net interest income since the middle of 2022 was largely **driven by higher margins on customer deposits**. Banks have been very slow in passing on recent increases in money market rates to their sight deposits; and when they have done, they have not passed them on in full. Whereas in the past few years they were generally unable or only partly able to pass on negative money market rates to retail customers and were forced to accept losses in this segment, the latter is once again generating noticeably positive margins.

For instance, **Commerzbank** aims to raise its net interest income from around EUR 4.9 billion in 2021 to more than EUR 6 billion in 2022 which, in our view, would appear to be a plausible goal based on the EUR 4.5 billion in interest earnings already recorded in the first three quarters of last year. Given its sizeable portfolio of corporate and retail customer deposits, which amount to a total of EUR 250 billion, the bank stands to be a major beneficiary of rising interest rates. Indeed, based on its own projections, it expects to generate additional income in this segment of approx. EUR 450 million in 2022 due to higher rates. Commerzbank estimates that these extra earnings will climb to as much as EUR 750 million in 2023 and EUR 950 million in 2024. It should be noted that the bank's planning involved assumptions about the extent to which

higher interest rates will be passed on to customers. Furthermore, it does not take into account any impact on customer loan volumes and margins - demand for mortgage loans is already falling considerably, which is driving the competition for margins. This situation contrasts sharply with a rapid increase in lending to corporates, which are ramping up their working capital and drawing down liquidity lines amid a business environment beset by crises.

At the banks we have analysed, the **interest rate sensitivity of net interest income** often translates to a gain of around 8 to 10 percent with a simultaneous shift in the yield curve of 100 basis points (without factoring in other effects, notably on volumes and margins).

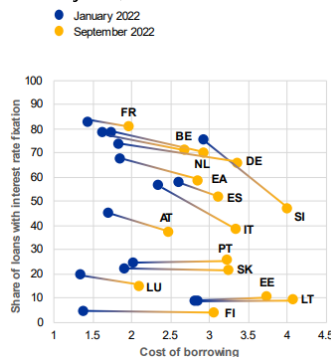


However, a positive impact on margins will be offset by an **anticipated decline in new business** in the corporate lending and retail mortgage segments. On the one hand, the weaker economic environment and higher interest rates will weigh on demand for loans; on the other hand, banks are adopting more stringent lending standards. Despite this, many banks should manage to achieve a **further year-on-year increase in net interest income of between 10 to 12 %** in 2023. Institutions with a high level of excess deposits will be the primary beneficiaries.

**In the medium term, banks will be able to refinance or reinvest their maturing loans and assets at higher yields.** Yet, the positive effect of this will also depend on the respective hedging strategy implemented and its related costs. In its blog, the **ECB banking supervision** recently highlighted deficiencies with respect to the monitoring of risks arising from derivative hedging transactions.

#### Interest rate fixation makes all the difference

Costs of lending and share of new loans with interest rate fixation periods of more than five years, in %



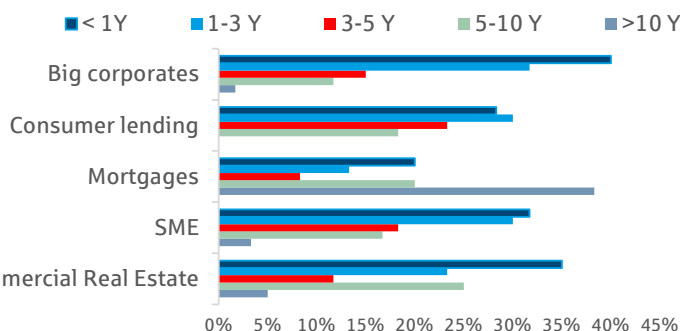
Sources: ECB Financial Stability Report, Helaba Research & Advisory

Furthermore, this strategy is based on medium-term durations and the **share of fixed-interest loans**. Some 40 % of banks surveyed by the European Banking Authority (EBA), for instance, reported that less than 20 % of their

residential mortgage portfolio is scheduled for repricing in the next twelve months. A similar percentage of banks reported interest rate fixation periods of more than 10 years at origination for the same loan portfolio. In contrast, for portfolios such as commercial real estate and corporate loans, banks reported a comparatively high share of loans repricing in the next 12 months as well as relatively low interest rate fixation periods at origination.

#### Gradual repricing of loan exposures

Interest rate fixation periods for loans at origination, share in %



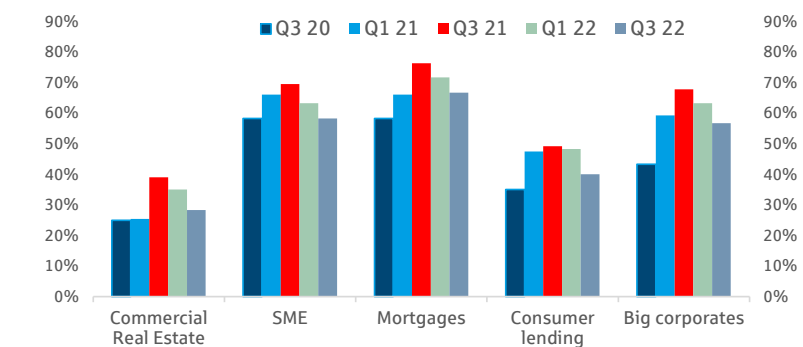
Sources: EBA, Helaba Research & Advisory

It is important to note in this respect that, depending on the hedging strategy adopted, the additional **net interest income will decrease as the yield curve flattens**. For example, in its recent blog the ECB supervisors write that some, albeit only a handful, of banks would face a significant increase in their funding costs under a flattening scenario that would be even larger than the projected increase in their earnings as their liabilities have a shorter maturity relative to their assets.

In spite of the uncertain macroeconomic situation, the **majority of banks plan to increase their exposure to corporate loans and residential mortgages**. This suggests that favourable interest margins are a more compelling factor for them than concerns over macroeconomic uncertainty. That said, the share of banks planning to increase lending volumes was lower in EBA's autumn 2022 risk assessment questionnaire than in previous surveys. We interpret this as an indication of concerns over downside risks.

### Declining expectations of higher lending volumes

Portfolios which banks expect to increase in volumes in the next 12 months, share in %



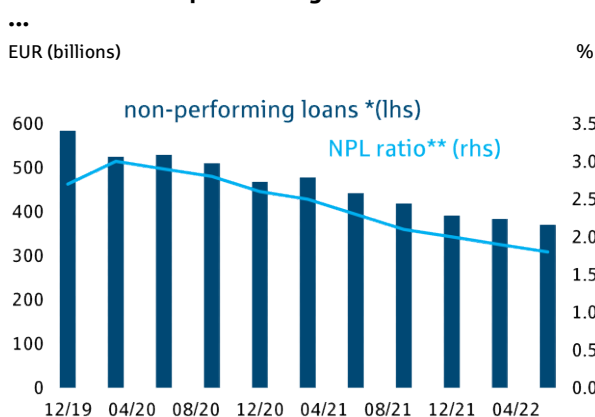
Sources: EBA, Helaba Research & Advisory

Another aspect worth mentioning is that most banks have made enormous efforts in recent years to **boost their fee and commission income** and have been successful in doing so. As a result, this comparatively volatile earnings component is now set to become a stabilising factor.

### 2.3 Will the long-anticipated rise in NPL ratios materialise?

Defying all the prophecies of doom, to date there has been no significant deterioration in credit quality on banks' books as a result of COVID-19. In fact, the **share of non-performing loans** as a percentage of total lending volumes in the sector has remained **at a historically low level**, with the recent downward trend continuing. In 2022, many banks wrote back parts of their unused COVID-19 related provisions; as a rule, they redesignated corresponding positions as provisions due to increased recession risks. In this way, banks are preparing themselves for an increase in credit defaults in 2023. The first signs of the latter are already visible as the ratio of loans for which indications of increased default risks were identified in the course of credit assessments (so-called **Stage 2 loans** under IFRS) has already risen sharply.

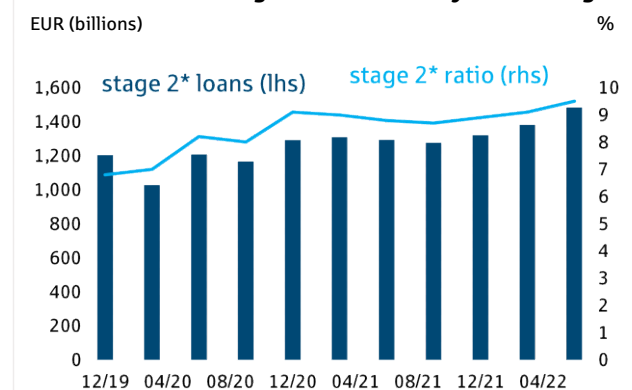
#### Volume of non-performing loans so far in decline



\*already impaired, \*\*share of non-performing loans as percentage of total lending volume

Sources: EBA, Helaba Research & Advisory

#### ... but volume of Stage 2 loans already increasing



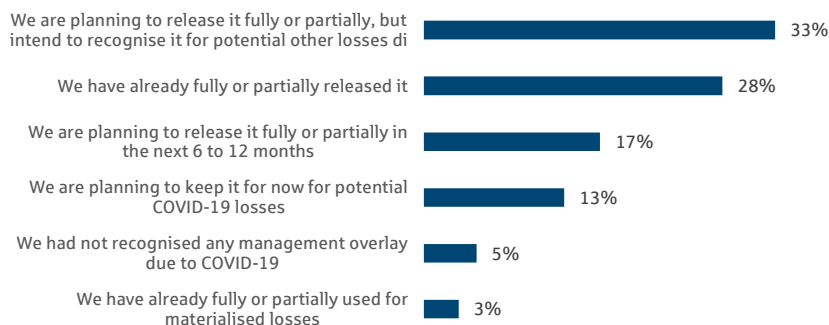
\*with significantly higher risk of default

Sources: EBA, Helaba Research & Advisory

That said, the banking sector weathered the COVID-19 crisis extremely well, with **moratoria expiring without any significant damage to asset quality**. Shortly after their roll-out in June 2020, eligible moratoria reached as much as EUR 871 billion, which was equivalent to around 7.5 % of banks' total credit portfolios. However, this was also followed by a quick run-off, indicating that these temporary measures were well suited to addressing borrowers' short-term liquidity problems.

### Banks have managed to write back most pandemic-related provisions

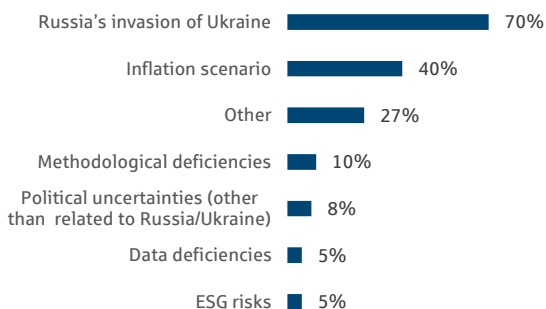
Planned treatment of COVID-19 overlays in banks' provisioning



Sources: EBA, Helaba Research & Advisory

### War in Ukraine and inflation the primary concerns

Reasons behind the provisioning overlays other than COVID-19



Sources: EBA, Helaba Research & Advisory

The findings of EBA's autumn 2022 questionnaire show that the **share of banks that expect their asset quality to deteriorate over the next 12 months** is 67 % for SMEs, 60 % for consumer credit and 52 % for large corporates. For residential mortgages, the expectation is somewhat more optimistic with a share of 32 %. In all segments, though, the findings were significantly higher than in previous surveys. Less than 5% of banks expect the quality of their loan portfolios to improve. S&P forecast that credit defaults in Europe will more than double this year.

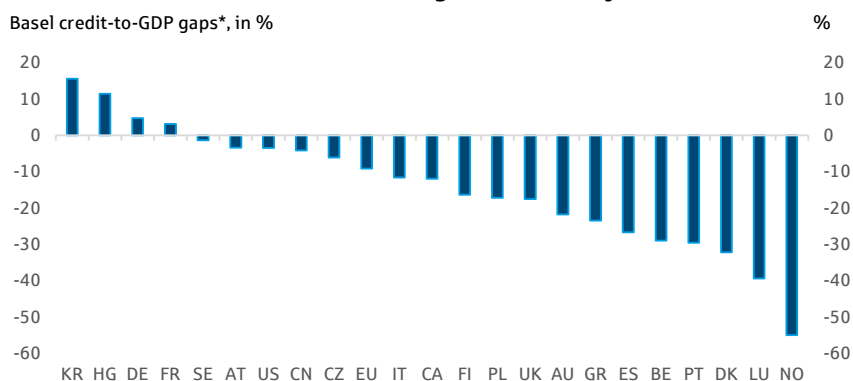
In our baseline scenario, we assume that there will be no need for gas rationing. According to Commerzbank, a scenario in which gas is rationed across Germany could result in additional loan loss provisions of EUR 500 to 600 million for the bank - around a fifth of its expected net profit before tax in 2023 based on analysts' consensus estimates.

## 2.4 Private sector debt gives cause for optimism, government debt at record levels

The Basel-based Financial Stability Board uses the gap between a country's private sector credit-to-GDP ratio and its long-term trend as a benchmark for determining prudential requirements (especially countercyclical capital buffers). The higher this value, the higher the emerging risks. Encouragingly, these indicators are negative or very low in Europe and, as such, **private sector debt ratios are pointing in a reassuring direction.**

### Private sector indebtedness trending lower in many countries

Basel credit-to-GDP gaps\*, in %

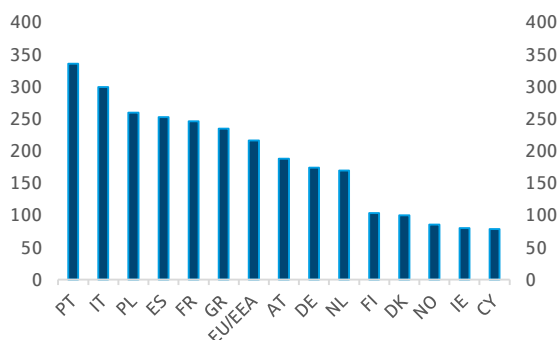


\*credit-to-GDP gap is defined as the difference between the credit-to-GDP ratio and its long-term trend; in percentage points. Based on total credit to the private non-financial sector, as % of GDP.  
Sources: BIS, Helaba Research & Advisory

However, the trend in public sector debt ratios is less promising. Banks maintain significant portfolios of sovereign bonds and, despite attempts to reduce it since the global financial crisis, the **nexus between sovereigns and banks** is still **extremely pronounced**. The Italian Unicredit Group, for example, has trimmed its portfolio of Italian sovereign bonds from almost EUR 60 billion at the end of 2019 to a most recent volume of around EUR 39 billion. As far as we can tell, the main objective was to reduce the dependency of its funding costs on Italy's sovereign rating.

### Pronounced sovereign-bank nexus

Sovereign exposures as % of capital



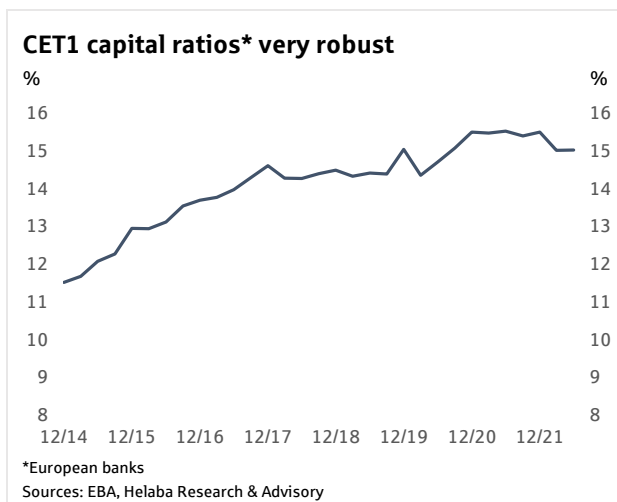
Sources: EBA, Helaba Research & Advisory

As of June 2022, EU banks reported around EUR 3.3 trillion of total exposures towards sovereign counterparties. This is up by almost 5.4 % from December 2021 (EUR 3.1 trillion). **Sovereign exposure reported by EU/EEA banks was equivalent to 217 % of their capital.** However, there was a wide divergence of this measure at both country level and at the level of individual banks. Banks in CEE and Southern Europe generally reported higher ratio of sovereign exposures to capital, while on average banks in Nordic countries reported a lower ratio.



## 2.5 High capital ratios as effective risk buffers

European banks' capital ratios, the **first line of defence for their ability to absorb losses**, are extremely high and provide a strong argument that the industry is well positioned to weather any potential risks. Capital ratios are twice as high as they were at the onset of the global financial crisis. The latter was the main driver for regulatory reforms introduced in its wake, which were recently supplemented by restrictions on dividend payments during the COVID-19 crisis. The cap on dividends imposed by the ECB banking supervision was lifted at the beginning of October 2021. Since then, major publicly listed banks have been paying out substantial amounts of accumulated surplus capital in the form of share buybacks and dividend payments. As we expect many banks to restore their capital ratios to pre-pandemic levels, share buybacks are likely to continue in 2023, too.

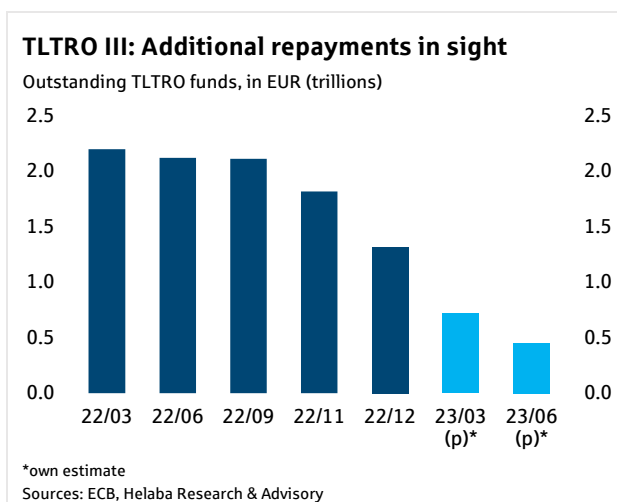


## 2.6 TLTRO repayments have implications for liquidity ratios

Up to now, banks have been using the option to repay funds borrowed from the ECB under the **TLTRO III programme** to a significantly lesser extent than analysts' consensus forecasts had anticipated. At its meeting on 27 October 2022, the ECB's Governing Council resolved to change the programme's hitherto extremely attractive conditions while granting banks participating in the programme the chance to return the funds they had borrowed. This early repayment schedule started on 23 November 2022, with **settlement dates on a monthly basis** thereafter.

According to the **settlement notice** of 18 November 2022, the total repayment amount was only EUR 296.3 billion versus consensus estimates of an average of approx. EUR 600 billion. On the second settlement date of 21 December 2022, banks repaid a total of EUR 447.5 billion. We believe that the relatively low take-up of the repayment option so far is primarily attributable to banks' desire, for the time being, to maintain existing liquidity ratios.

**We anticipate** that institutions will return another EUR 600 billion of the roughly EUR 1.3 trillion still outstanding between January and March 2023 (next settlement notice on 13 January). Since the end of 2022, the high volume of funds maturing in June 2023 (around EUR 0.63 trillion still outstanding) has no longer been eligible for inclusion in the net stable funding ratio (NSFR) calculation. Funds maturing in June were at least still eligible to be counted towards the liquidity coverage ratio (LCR) at the end of 2022. Some banks, particularly those from the euro periphery, seem to have found this attractive since the pricing of these funds is still below money market rates. In March 2023, the LCR eligibility of the TLTRO III amounts due in June 2023 will then also enter the external reporting for the last time.





Our assumption is that a rapid increase in banks' net interest income from their core activities will more than offset the gradual absence of additional earnings generated by the ECB's TLTRO III programme. **Repayments of TLTRO funds will lead to declining LCR ratios**, although from a very high level. Banks have already priced in this impact.

### 3 Primary market outlook 2023: Substantial maturities to drive abundant issuance

The total volume of euro-denominated, senior unsecured bank bonds with fixed coupons issued on the primary market amounted to **just over EUR 180 billion for 2022 as a whole**; 60 % of these funds were raised in the non-preferred category. Overall, it turned out to be a record year with year-on-year growth of 30 % that was largely driven by a high level of maturities, minimum requirements for bail-in capital and prefinancing transactions in an environment of widening credit spreads (see also "[Primary market update EUR benchmark bank bonds: Q4 2022](#)" of 9 January 2023).

**For 2023**, we expect activity on the primary market to remain similarly buoyant and forecast a **total issuance volume of around EUR 180 billion**. Although we assume that the volume of senior preferred issues will see a modest year-on-year rise of 10 % to EUR 80 billion, we anticipate that the non-preferred ranking will decline by 6 % to EUR 100 billion.

#### Outlook for 2023: Maturities to remain very high

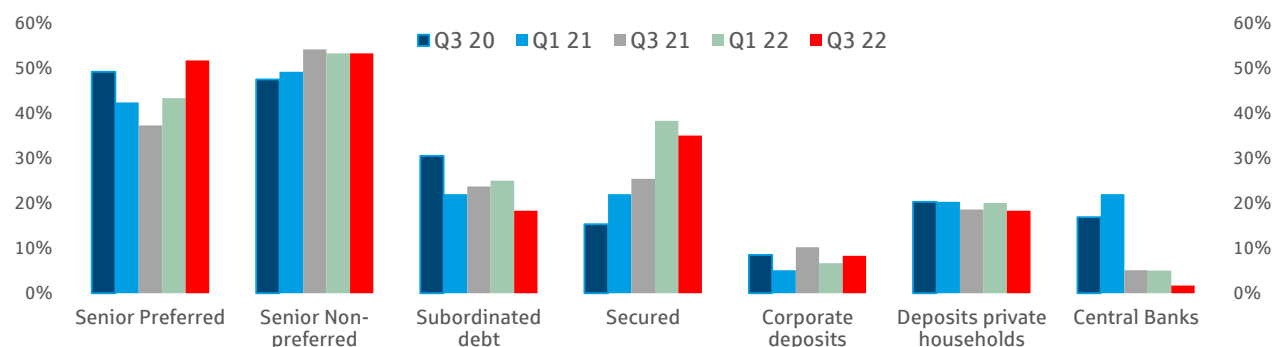
Maturities by country, EUR (billions)



Sources: Bloomberg, Helaba Research & Advisory

#### Senior preferred notes a popular instrument with issuers

Funding instruments in the next 12 months, share of all responses\*

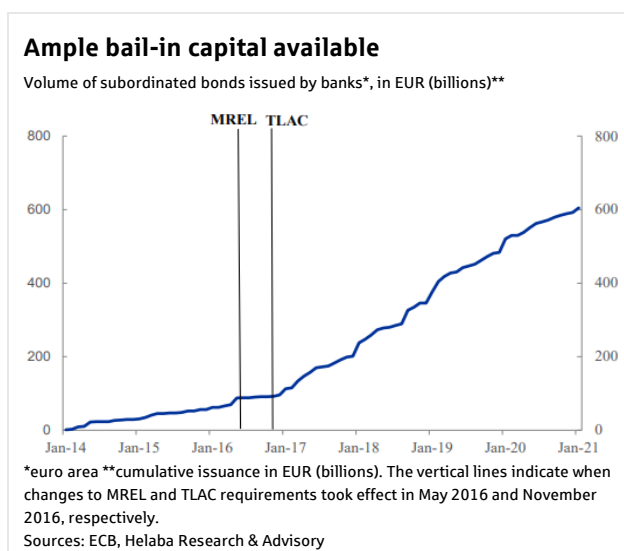


\*EBA survey among banks

Sources: EBA, Helaba Research & Advisory

In our opinion, a **renewed high level of maturities will be the main factor** fuelling activity in 2023. As far as senior preferred issues are concerned, additional support will come from TLTRO repayments and relatively narrow spreads. At the same time, regulatory requirements will drive the issuance of senior non-preferred notes. Prefinancing transactions that were completed in 2022, on the other hand, will act as a counterweight to this. Additionally, the economic slowdown suggests that lending activity will weaken, especially in the corporate finance segment, while there could be an outflow of customer deposits due to the high cost of living.

As the market environment continues to be volatile and beset by various crises, **getting the timing right remains a challenge**. As in 2022, banks will take full advantage of any open windows in the market - even at elevated spread levels.



A number of banks still have to issue **MREL-eligible** debt in order to close shortfalls in the required eligible amounts by 1 January 2024 - the deadline for compliance with MREL requirements pursuant to the Bank Recovery and Resolution Directive 2 (BRRD 2). However, in our view, this should only be a marginal factor as issuance activity is expected to be very substantial anyway and **larger banks with significant capital market operations, in particular, have long since met their requirements - in most cases very comfortably**. Some smaller banks, though, may still have some catching up to do in this regard (see also "[Regulatory call option for non-preferred bonds becoming standard](#)" of 2 August 2021).



## A selection of recently published analyses

- [PRIMARY MARKET UPDATE: EUR BENCHMARK BANK BONDS](#)
- [SINGAPOREAN COVERED BONDS: PRIME CREDIT QUALITY MADE IN ASIA](#)
- [EUROPEAN BANKS: Q3 RESULTS INSTIL CONFIDENCE](#)
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