Tightening credit conditions set to further worsen the credit profile of Italian banks

by Claudio Bonvino

- **NUS-CRI Forward PD of Italian banks suggests a short-term deterioration in credit quality as their profitability and asset quality remain under pressure in the current monetary tightening environment**
- **Stress tests indicate that a further monetary policy tightening by the ECB will negatively impact Italian Banks' Agg PD, especially for systemically important banks (SIB), as shown by the increasing stressed Agg PD of the top 10 Italian CriSIBs**

The Italian banking system, in conjunction with the wider European banking sub-sector, has seen a deterioration in its credit profile due to the tightening monetary environment in the European Union (EU) as the European Central Bank (ECB) continues to tame inflation, increasing Italian banks' funding costs, while simultaneously pressuring its asset quality. Reaching levels in line with those suggested by the Forward PD in our Jun-2022 issue, the NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) of Italian banks steadily increased since the beginning of last year. Although leading Italian lenders have limited exposure to the banks collapsing in the recent crisis, the impact of interest rate hikes on the whole sub-sector's credit risk profile has increased its Agg PD close to the non-investment grade threshold of BBB- upper bound when proxied by PDiR2.0[1]. Looking ahead, the NUS-CRI Aggregate (median) Forward 1-year Probability of Default (Forward PD)[2] for the Italian banking sub-sector suggests a further worsening of their credit risk profile over the coming 12 months, deteriorating to the BB+ upper bound. Though the trend seems to impact the majority of the banks domiciled in Europe (see Figure 1b), stress tests conducted using the NUS-CRI BuDA toolkit suggest that systemically important Italian banks are particularly vulnerable to changes in ECB's policy rates.

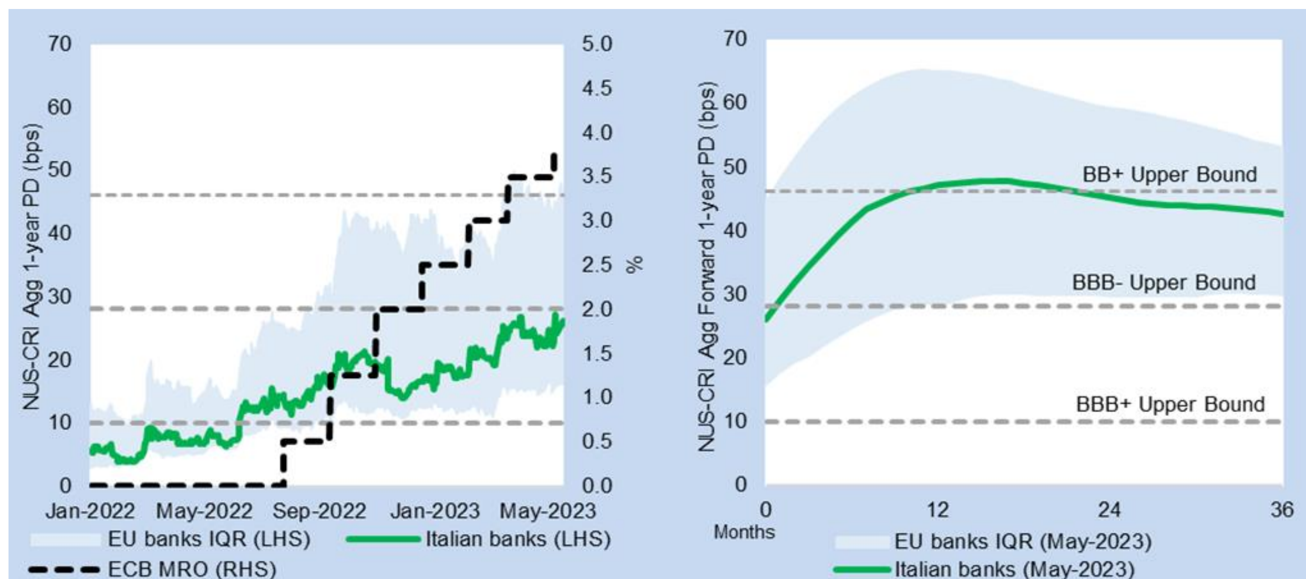

Figure 1a (LHS): NUS-CRI Agg (median) 1-year PD for Italian banks from Jan-2022 to May-2023 with their interquartile range (IQR) of all European banks, with reference to PDiR2.0 bounds; the ECB interest rate on the main refinancing operations (MRO) from Jan-2022 to May-2023. Figure 1b (RHS): NUS-CRI Agg (median) Forward 1-year PD for Italian banks and IQR of European banks as of May-2023 with reference to PDiR2.0 bounds. *Source: NUS-CRI, ECB*

[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 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.

As the ECB remains committed to raising rates, the benefits derived by Italian banks from rising interest incomes are under threat of dissipating. With borrowing costs high and the economic outlook weak, Italian banks are now contending with significant declines in credit growth across segments. Year-on-Year growth in new bank loans to non-financial corporates and households has consistently exhibited a declining trend since the second half of 2022. Although credit growth declines of all European banks outpace that of Italian banks, the trend is expected to worsen, potentially adding pressure on banks' near-term profitability prospects. The recent Euro area bank lending survey also shows that banks are tightening lending standards at a record pace in response to weakening macroeconomic factors, hampering the supply of credit extended by banks further.

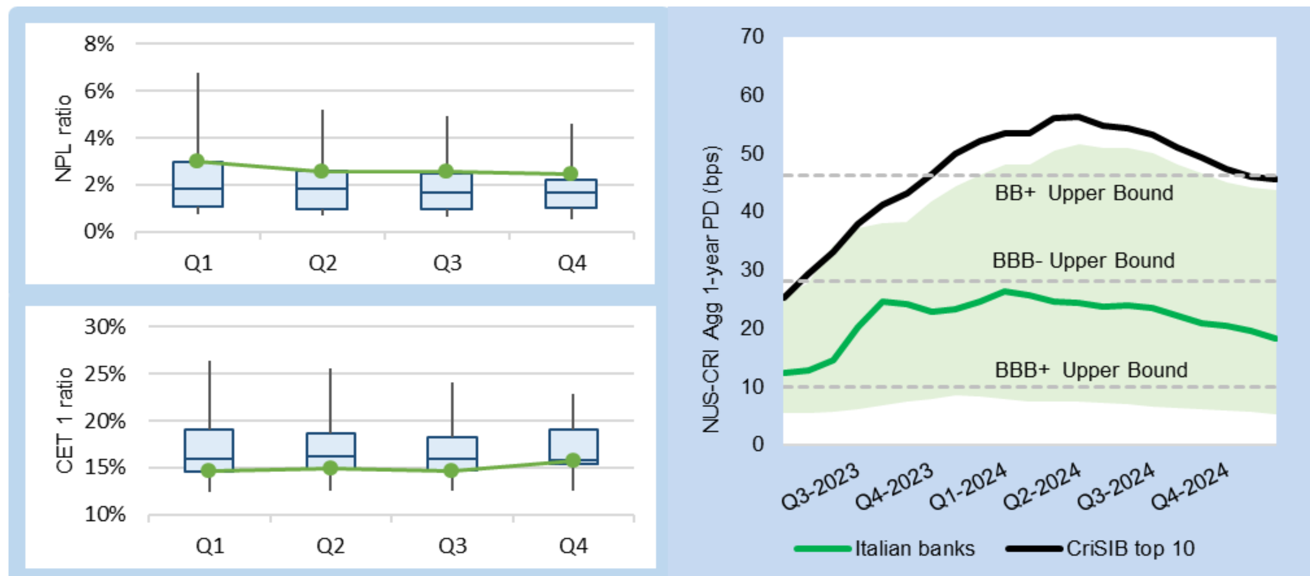

Figure 2a (LHS): Non-performing loan (NPL) ratio and Common Equity Tier 1 (CET 1) ratio in 2022 for significant Italian banks in green, with the box plots of all European banks. Figure 2b (RHS): Stressed NUS-CRI Agg (median) 1-year PD of Italian banks and CRiSiB[3] top 10 banks based on ECB's potential interest rate hikes contextualized by the interquartile range of all Italian banks, with reference to PDiR2.0 bounds. *Source: ECB, BuDA V3.5.1*

So far, Italian banks have exhibited robust profitability and liquidity in 2022 as interest income from floating rate loans increased 23% YoY, providing a reprieve to their ability to service their obligations. The exit from the TLTRO III by Jun-2023 should have a limited impact on Italian banks considering the current liquidity level. Nevertheless, as suggested by Agg PD and Forward PD in Figure 1, the ECB's continued interest rate hikes, and the resultant economic slowdown, threaten both the profitability and the asset quality of Italian banks. Particularly, higher inflation and interest rates affect the borrowers' ability to meet their obligations, especially for small and medium-sized enterprises (SMEs), which make up the majority of Italian banks' assets portfolios. The marginal decline in Italian banks' NPL ratio registered in 2022 (see Figure 1a) may be pressured as loan delinquencies rise, especially in interest-sensitive loan segments such as the construction sector. Though the NPL ratio seems to be declining, it is still higher than the upper quartile of its European counterparts. Furthermore, as shown in Figure 2a, though the sub-sector remains well capitalized with the CET1 ratio above regulatory requirements; compared to the rest of the EU, Italian banks' have lower loss absorption capabilities. This may suggest why the Italian banks' Forward PD (as seen in Figure 1b) is worsening, especially in the current macroeconomic environment where bank asset values are on the decline.

Using the NUS-CRI Bottom-up Default Analysis toolkit (BuDA Toolkit v3.5.1[4]), stress tests can be conducted to further evaluate how sensitive Italian banks are to further policy tightening by the ECB[5]. As shown in Figure 2b, successive interest rate hikes maintained until the end of this year to a target policy rate of 4.25% would lead to a deterioration in the credit profile of Italian banks, especially for those systemically important Italian banks (those that are ranked in the top 10 CriSIB at the end of Q1 2023). A successive rise in interest rates is likely to hamper credit extension to households and companies, while simultaneously impacting the asset quality of the

[3] CriSIB is the ranking of systemic importance for exchange-listed banks around the world. It is dynamic by nature, and it determines a firm's systemic risk by its size and interconnectedness with others. A higher ranking of a firm means it is likely to pose a larger threat to the global (group) financial system. The banks in this sample include Intesa Sanpaolo SpA, Banca Monte dei Paschi di Siena SpA, BPER Banca , Banco BPM SpA, UniCredit SpA, Mediobanca Banca di Credito Finanziario SpA, Banca Popolare di Sondrio SPA , Credito Emiliano SpA , FinecoBank Banca Fineco SpA

[4] The Bottom-up Default Analysis (BuDA v3.5.1) is a credit stress testing and scenario analysis toolkit jointly developed by the Credit Research Initiative (CRI) team of the National University of Singapore (NUS) and the International Monetary Fund (IMF).

[5] The scenario simulated on the BuDA toolkit assumes ECB's policy rates will increase to 4.25% until Jul-2023 and remain at that level until the end of 2023. The policy rates begin to gradually decrease by 25bps MoM in the first three quarters of next year, before remaining stable at the long-term policy rate of 2% till the end of 2024.

incumbent loan portfolio negatively due to higher servicing costs for borrowers. Furthermore, for systemically important banks that are likely to have a higher exposure to government securities through investments, further monetary tightening by the ECB is likely to reduce the value of their investment holdings, impacting Italian SIBs' leverage and profitability metrics in the short term. Exposure to the worsening monetary environment may suggest the steep rise in the term structure of the Forward PD in Figure 1b for the most vulnerable and systemically important Italian banks. Therefore, even though Italian banks' fundamentals provide a slight silver lining to their current credit profile, tightening credit conditions amidst a potential recessionary backdrop may lead to a worsening of their credit risk outlook.

Credit News

US bank deposits fall for a third week while lending stays little changed

May 19. US bank deposits experienced a third consecutive week of decline, reaching the lowest level in nearly two years. This ongoing trend is attributed to customers seeking higher returns in money-market funds rather than keeping their funds in traditional bank deposits. According to seasonally adjusted data released by the Federal Reserve, deposits at commercial banks decreased by USD 26.4bn, amounting to a total of USD 17.1 tn. (Bloomberg)

Investors seek protection in case of debt-ceiling debacle

May 21. Investors are concerned about the potential volatility that could arise from the ongoing debt-ceiling stalemate in the United States. Despite the S&P 500 reaching its highest levels since August, many investors remain cautious and adjust their investment strategies, anticipating increased market volatility and seeking refuge in safer assets such as longer-term Treasury bonds. Investors have withdrawn cash from stock funds for the seventh consecutive month and are seeking safety in longer-term Treasury bonds. Refinitiv Lipper data reveals that nearly USD 24 bn has been pulled from US equity funds in the first three weeks of May. (WSJ)

Rise of 'shadow credit' as consumers turn to risky loans

May 20. Consumers in the UK have increased their reliance on "shadow credit" as the cost of living crisis in the country intensifies. Consumers have been taking out riskier and unregulated loans to meet higher household costs. This is in stark comparison to a decade ago when credit-related stress was based in the banking system, whereas currently, stress is housed in "buy-now, pay-later" schemes for utility bills or private credit between households. Even though the UK economy is facing high interest rates and double-digit inflation, UK banks have remained resilient due to robust asset quality. The potential for spillovers from the shadow banking system into traditional banking poses significant risk and may impact BoE policy. (FT)

Regional banks could tap debt market after Charles Schwab raised USD 2.5bn in bonds

May 22. US regional banks could tap into the investment-grade bond market to raise funds after Charles Schwab Corp. successfully issued USD 2.5bn in bonds. Regional banks may need to tap into debt markets for USD 25bn to increase their total loss-absorbing capacity. Though borrowing costs remain high, the spread on financial corporates above treasuries tightened over the past week by four basis points, compared to that of non-financial firms which tightened by a marginal one basis point. Regional banks need to ensure that they hold sufficient liquidity and return to profitability after SVB's default, with the former being affected by their access to primary markets. (Bloomberg)

US companies pull forward bond deals amid debt ceiling nerves

May 22. Corporate borrowers are taking advantage of the current favorable market conditions to secure funds from investors before any potential volatility arises from the US government facing a cash shortage. Such a scenario could have widespread implications for global asset prices. Bankers involved in corporate bond deals report that companies are eager to tap into the market while it remains relatively stable. Highly rated companies have accelerated their bond issuances, with a total of USD 112bn issued so far this month, which is significantly higher than the USD 46bn issued in May 2022 and more than triple the amount issued in April. (FT)

Credit Suisse staff prepare to sue regulator Finma over lost AT1 bonuses (FT)

SoftBank explores plans to become a lender in private credit (Bloomberg)

China's USD 23tn local debt mess is about to get worse (Bloomberg)

Regulatory Updates

China's banks keep lending rates unchanged after PBOC's hold

May 22. Benchmark rates for Chinese banks have remained unchanged despite signals by the market to the PBOC to begin monetary easing, spurring dwindling economic recovery. The one- and five-year loan prime rates remained stable at 3.65% and 4.30% for the ninth consecutive month, in line with market forecasts. Decelerating industrial output, retail sales, and fixed investments in Apr-2023, in conjunction with low credit expansion and near-zero inflation, is putting pressure on Beijing to support the economy with further policy stimulus. Despite the cut in RRR that happened last month, a further 25bps cut is expected by some market participants by next month, potentially boosting market sentiment and supporting credit growth. (Bloomberg)

Fed's Bullard suggests higher rates as 'insurance' against inflation

May 19. James Bullard, President of the St Louis Federal Reserve and the central bank's foremost hawks, is poised to back further rate hikes by the Fed as an 'insurance' measure against inflation. Though Mr Bullard is expecting disinflation moving forward, he deems the pace at which prices have been falling to be too slow. Among other FOMC members who feel aligned to increase rates. Some members of the FOMC, like the next vice-chair of the Fed Philip Jefferson, feel that the impact of the rising rates is likely to be lagged and may yet slow down the economy in the coming months, catalyzed by the recent banking crisis that has reduced credit extension in the private markets as lenders remain cautious. According to Bullard, a restrictive monetary policy that will be sufficient to curb inflation completely sits between 4.75% to 6%. (FT)

Libor rigging in 2008 crisis was 'state-led,' Times says (Bloomberg)

Bank of Korea to hold rates until end of September, cut in Q4 (Reuters)

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