

S&P Global Ratings

Credit Conditions Europe Q3 2022

Pain On The Horizon

June 28, 2022

(Editor's Note: S&P Global Ratings' Credit Conditions Committees meet quarterly to review macroeconomic conditions in each of four regions (Asia-Pacific, Emerging Markets, North America, and Europe). Discussions center on identifying credit risks and their potential ratings impact in various asset classes, as well as borrowing and lending trends for businesses and consumers. This commentary reflects views discussed in the European committee on June 20, 2022.)

Key Takeaways

- **Overall:** A rapid deterioration in global macroeconomic conditions, combined with ongoing geopolitical uncertainty and lingering COVID-19 lockdowns in China are fueling persistently high inflation, market volatility, and rising yields, posing an increasingly murky outlook for credit quality that—for now at least—exhibits a degree of resilience built up during the bounce-back from the pandemic.
- **Risks:** Key risks relate to: the outlook for energy and food as supply disruptions linked to Russia's invasion of Ukraine intensify, a rapid adjustment of central bank policy rates to counter excessive inflationary pressures, stagnant growth weakening the operating environment and financial performance of corporates, tightening financing conditions reawakening fears over fragmentation within the eurozone, and the debt sustainability of more vulnerable entities.
- **Ratings:** Credit ratings are likely to come under more pressure into 2023 as supply constraints keep food and energy prices elevated, households increasingly struggle with falling real incomes, and central banks prioritize inflation over growth. Tighter financing and operating conditions will refocus business and households on cash flow to protect against a highly uncertain outlook and ultimately solvency for the most vulnerable debtors. We expect default rates to increase to about 3% by year-end and into the first quarter of 2023.

With central banks actions squarely aimed at bringing down very high inflation, growth will be a casualty. After a strong start, we expect eurozone GDP to stagnate for the rest of 2022, giving GDP growth of 2.6% for the year and 1.9% for 2023. While we expect inflation to peak this year, the effect of higher prices and higher interest rates will obviously continue to erode household disposable incomes and raise corporate input costs even as the rate of inflation declines in 2023 and beyond.

Steep declines in consumer confidence across Europe indicate ongoing challenges for some corporates. Rapid—and in some cases very steep—rises in fuel, energy, and food prices, and continued tensions from Russia's invasion of Ukraine have severely dented consumer confidence. Although some are now benefiting from the release of pent-up consumer demand, particularly for the leisure, airline, and hotel sectors as travelers follow through with summer vacation plans even at higher prices, we expect that effect will dissipate after the summer and into 2023.

More broadly, higher energy and other input costs will increasingly squeeze margins for European corporates. So far, companies have broadly been able to pass through higher costs to customers thanks to very robust demand. As these factors fade and growth slows, maintaining profitability will become more difficult for many, particularly for companies more reliant on discretionary spending trends or with more energy-intensive production. Speculative-grade issuers are generally less able to cope given their narrower product ranges and weaker capital structures.

Important bright spots: a still-high stock of household savings, low unemployment, and robust corporate balance sheets. While the flow of household savings has declined from pandemic peaks, the still-high level of household net wealth is buffering the effects of rising prices, at least for now. Moreover, with European job vacancies at record highs and unemployment at multidecade lows, unless the outlook worsens considerably than our base case, companies may want to cling to their

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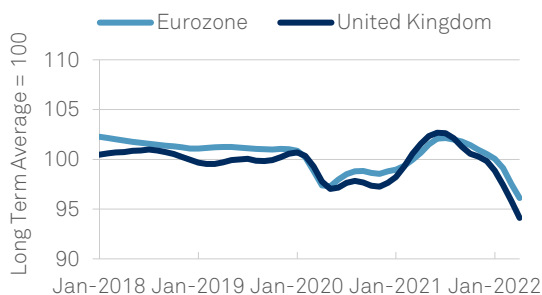
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workers, even as growth slows and margins come under pressure. In the near term though, corporate balance sheets at the start of the year and into the first quarter benefited from the rebound in activity as the pandemic waned. Refinancing risk is also limited in the near term, given that many companies took the opportunity of ultraloose monetary conditions in recent years to refinance their debt.

Chart 1

European Consumer Confidence Has Plummeted...

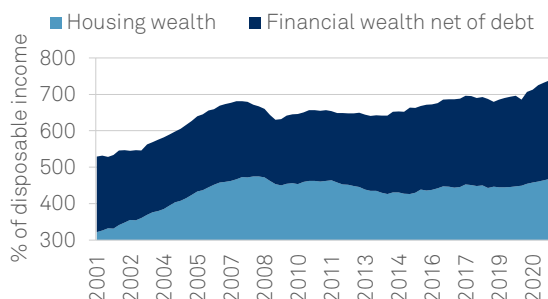
OECD Consumer Confidence Indicator.



Data to end May 2022. Source: OECD

Chart 2

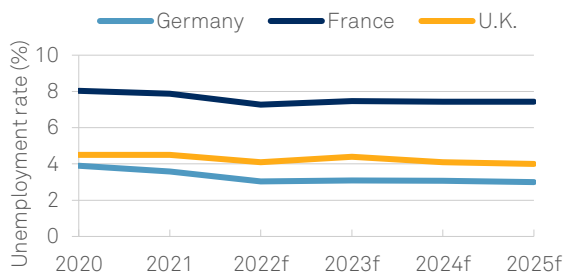
...But Record Levels Of Household Net Wealth Provide A Buffer Against Rising Prices



Source: S&P Global Ratings

Chart 3

Unemployment Levels Are Low...

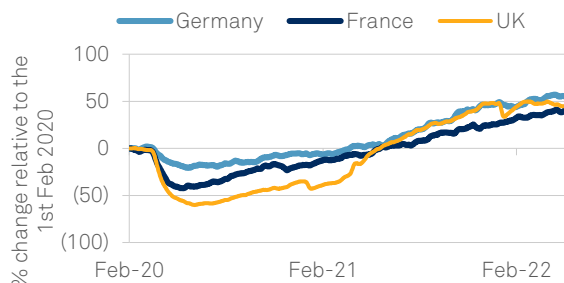


Source: S&P Global Ratings

Chart 4

...While Job Vacancies Remain High

Online job postings, selected countries



Source: Indeed, S&P Global Ratings

Fragmentation risk resurfaces for the eurozone. The ECB announcement of its intention to move toward policy normalization—through upcoming hikes in policy rates as well as the end of preferential rates on TLTROs and net asset purchases—meant that yields in some eurozone countries such as Italy and Spain rose to multiyear highs, reflecting concerns about their perceived greater vulnerability to rising rates. While the ECB's announcement on June 15 that it would accelerate its work on designing a new antifragmentation instrument calmed markets, the details about how such a tool would work and extent to which it can be deployed will be crucial in determining whether the central bank can ensure an even transmission of its monetary policy goals across the eurozone.

We expect the Russia-Ukraine conflict will drag on. As assessed by S&P Global Market Intelligence, the Russia-Ukraine conflict has entered a phase of costly attritional warfare. Russia's likely minimum objective is to capture all of Donetsk and Luhansk regions, which would allow Russia to annex territory and the Kremlin to claim victory. Russia will seek to maintain its blockade of Ukraine's coasts and ports, seriously disrupting marine traffic in the Black Sea through 2022. If Russia succeeds in its objectives in the east, it will probably seek to consolidate its territorial gains, either through negotiation or by declaring a unilateral ceasefire. A further round of European sanctions in 2022 is unlikely to include Russian gas imports to the EU, given European dependence on Russian gas and the significant differences among EU members on this issue. Still, the risk of Russia cutting its supply to Europe further is rising.

Our downside scenario posits a global slowdown emanating from the U.S. and an extended energy price shock. The scenario sees persistently high inflation in U.S.—resulting in a more aggressive

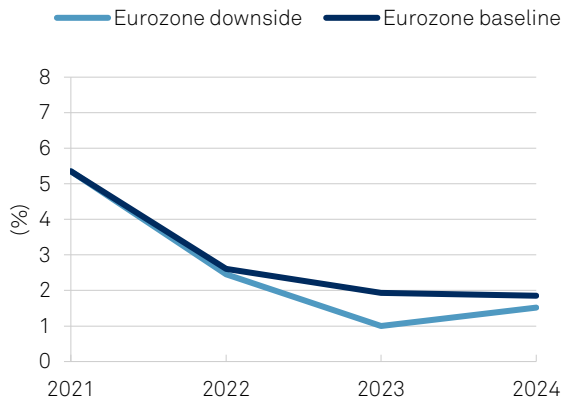
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monetary policy response from the U.S. Federal Reserve—and continued dislocation in energy markets from the ongoing conflict in Ukraine. During first-quarter 2023, we assume Brent will reach \$155 per barrel (50% higher than the baseline) and European gas prices to rise to \$40/mmBtu. For Europe, this results in higher inflation that peaks at close to 9% and at 10.5% at the end of this year for the eurozone and the U.K. respectively.

The scenario’s impact on eurozone GDP shows growth slowing to 1% in 2023, with the more industrial German economy experiencing the sharpest slowdown to 0.6%, compared with 2.0% in our baseline in 2023. For the U.K., a tighter labor market, building wage pressures, and an amplified commodity price shock should result in the central bank front-loading interest rate hikes to depress demand even as real disposable incomes fall. U.K. GDP growth could experience a growth recession in 2023 with growth slipping to 0.6%.

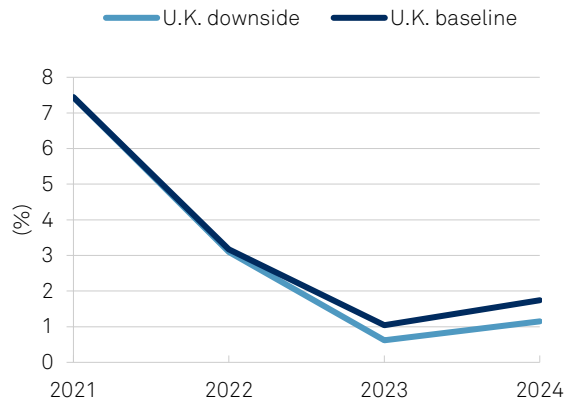
Unemployment is less affected than in the U.S. – indeed hardly at all in the eurozone, reflecting relatively stickier labor markets, a high level of job vacancies and little prospect of full recession in this scenario.

Chart 5
Downside Scenario – Eurozone GDP



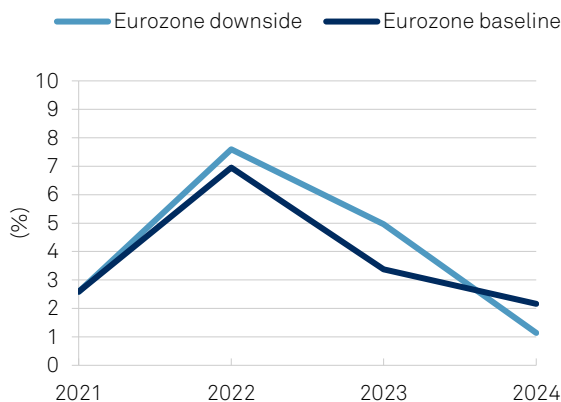
Source: S&P Global Market Intelligence, S&P Global Ratings

Chart 6
Downside Scenario – U.K. GDP



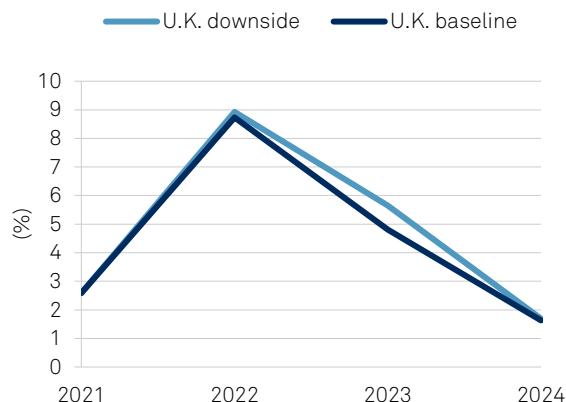
Source: S&P Global Market Intelligence, S&P Global Ratings

Chart 7
Downside Scenario – Eurozone CPI Inflation



CPI—consumer price index. Source: S&P Global Market Intelligence, S&P Global Ratings

Chart 8
Downside Scenario – U.K. CPI Inflation



CPI—consumer price index. Source: S&P Global Market Intelligence, S&P Global Ratings

This scenario is not intended as a worst-case forecast. We have focused on developing a scenario that reflects a reasonably possible downside. That is why we don’t include, for example, a complete

shutoff of Russian gas supply to Europe or gas supply disruptions requiring rationing of production in Europe.

Other key messages

- **Financing conditions: Sharply rising credit risk premiums and a drought in issuance.** A steep acceleration in credit risk pricing in June means speculative-grade spreads are at their highest point since the pandemic-induced peak in the first half of 2020, while investment-grade spreads have doubled since the start of 2022. European nonfinancial corporate debt issuance is down by almost one-third so far this year, and speculative-grade issuance has all but collapsed in recent weeks. While near-term refinancing risk looks manageable for most, with just 22% of lower-rated ('B-' or lower) EMEA nonfinancial corporate issuers we rate facing debt maturities through 2023, we note that the media and entertainment sector and the capital products sector account for the largest number in this cohort.
- **Sovereigns: 2022 is already proving to be a tough year for European sovereigns, and 2023 looks to be even more so.** Demand and supply shocks, the ongoing Russia-Ukraine conflict, and deglobalization are putting a drag on confidence and productivity, pushing up both inflation and inflationary expectations, and vulnerability to interest rate shocks. A shock rise in yields of 300 basis points (bps) from their current levels—not our base case—would raise sovereigns' interest costs as a proportion of GDP to levels last seen in 2012 for some. For example, for Italy the ratio of interest expense to GDP would rise to 5.5% by 2025 from its current level of 3.7%.
- **Financial institutions: Rising interest rates will support European banks' earnings, even as weaker economic growth, market volatility, and inflationary pressure absorb some of that benefit.** A limited need for market funding means banks funding costs are unlikely to suffer much from wider spreads for now. The recent and steep repricing of risk will have a more immediate, though manageable, impact on bank capital ratios, with banks in countries where yields have widened the most being potentially more affected. While bank asset quality may deteriorate from a possible emergence of problem loans, it would be from a starting position of asset quality strength, and we see credit losses remaining contained.
- **Nonfinancial corporates: Margin pressures are building for many companies, which face a diminishing ability to pass through higher costs to customers as demand moderates.** Even as inflation rates abate next year, such pressure may continue as companies face the renewal of hedging and supplier pricing agreements at new, higher rates. While refinancing needs are not pressing for many, thanks to significant levels of capital raising at low rates in recent years, access to refinancing is more challenging and costly, particularly for weaker borrowers.
- **Structured finance: Rises in the cost of living and interest rates heighten the risk of underlying consumers in European structured finance transactions falling behind on debt repayments, particularly for mortgages:** Borrowers' sensitivity varies across Europe, depending on local inflation and the prevalence of floating-rate versus fixed-rate loans. A key mitigant is that unemployment—which has in the past been much more highly correlated with our structured finance ratings than inflation—should remain broadly flat over our forecast period.
- **Insurance: Over 500 planes grounded in Russia represents a key insurance exposure.** The situation may also lead to material insurance claims in specialty lines like political risk, war, all-risk cover, and aviation. However, claims would likely take a long time to be settled. Rising interest rates are broadly positive for the sector.
- **International public finance: Local and regional governments are benefiting from improving performance as inflation boosts revenues for now.** Public-sector enterprises might suffer, however, given potentially limited scope to raise fees in the face of steep rises in the cost of living.

Top European Risks

Table 1

Further commodity supply shocks and persistent inflation extend pricing pressures, weakening earnings

Risk level Very low Moderate Elevated **High** Very high **Risk trend** Improving Unchanged **Worsening**

We see a high risk that the war in Ukraine drags on, sanctions against Russia or Russia's supply of gas to Europe continue to tighten, putting further upward pressure on energy prices. Oil prices may spike further as the EU embargo on shipped oil and the Western prohibition against insuring Russian oil shipments play out, in combination with strong seasonal demand and a recovery in demand in China. Russian actions to further significantly curtail gas supplies could cause energy prices to spike further if supply restrictions prevented European gas storage replenishment before next winter, leading to gas rationing and a consequent hit to economic activity across Europe. Dislocation in the agricultural markets also feeds into food scarcity for certain key staple products, maintaining upward pressure on consumer prices. These factors could result in inflation pressures persisting well into 2023, and, in a slowing growth environment, presenting increasing challenges for companies in certain sectors to maintain margins by continuing to pass through higher input costs to their customers. Should these cost pressures continue to build and demand growth fall steeply, the impact on corporate profits could threaten credit quality.

A growing geopolitical schism as the world order fractures

Risk level Very low Moderate Elevated **High** Very high **Risk trend** Improving Unchanged **Worsening**

The conflict threatens a deeper geopolitical schism between autocratic and democratic blocs that could undermine decades of economic cooperation and development, with widespread implications for global security, trade, supply chains, communications, the environment, and global health. The conflict also threatens to destabilize lower-income countries in Africa as higher food prices lead to greater food poverty, which in the past has caused social upheaval and triggered migratory flows of people toward Europe.

Dislocation in funding markets as the ECB and other central banks accelerate monetary policy tightening to tackle high inflation

Risk level Very low Moderate Elevated **High** Very high **Risk trend** Improving Unchanged **Worsening**

Despite recent rises in policy rates, debt-servicing costs remain historically low. Yet the enormous step-up in corporate and sovereign debt since the pandemic means that fragilities may become more pronounced were rates to rise more sharply than we expect in the coming years, especially for corporates, given the still high (around 30%) of speculative-grade companies (rated 'B-' and lower) that we view as vulnerable. A structural challenge of strengthening balance sheets extends to governments and central banks. This will be a multiyear process with the risk that political considerations could impede and delay the budgetary tightening required to maintain sovereign credit quality and restore the fiscal headroom necessary to fight the next financial shock.

ECB monetary policy tightening reawakens fears of fragmentation in the eurozone

Risk level Very low Moderate **Elevated** High Very high **Risk trend** Improving **Unchanged** Worsening

The limited supply of supranational eurozone assets eligible for the ECB's monetary policy operations and the consequent need to use national instruments result in greater fragmentation in the eurozone—that is, significant variance in borrowing costs for similar private-sector entities operating in different eurozone jurisdictions—reducing the creditworthiness of households, corporates, and sovereigns with vulnerable balance sheets. We note that Italy's 10-year bond yield widened around 313 bps to 3.85% over the last year, compared with 207 bps (to 1.83%) for German Bunds. If that widening in Italian yields repeats itself over the next few months, we estimate that the additional fiscal cost of debt servicing would amount to just under 2 percentage points of the country's GDP by end-2025, returning its cost of debt to 2012 levels.

Structural Risks

Security of energy supply eclipses the energy transition in the short term

Risk level Very low Moderate **Elevated** High Very high **Risk trend** Improving Unchanged **Worsening**

The Russia-Ukraine war starkly exposed the risks of European reliance on Russian oil and gas. Despite the drive toward sustainable energy sources over the longer term, supply security concerns will remain dominant in the near term, even at the cost of delaying the phase-out from carbon-intensive energy sources. We have already seen some restarts of coal plants in Germany and elsewhere, and European LNG imports are set to jump this year by more than 50 bcm. At the same time, the political priority to end Russian gas reliance by 2027 will ultimately involve an acceleration of the energy transition, with more ambitious plans for renewables, biomethane, energy efficiency, and accelerated heat-pump rollouts. The growing gap, between current emission trajectories and those needed to align to a 1.5 degree Celsius target by 2030, may lead to societal tension as policymakers struggle to balance short-term social and economic priorities with long-term decarbonization ambitions. This may trigger abrupt policy actions in later years, disrupting industries and business models (notably in the automotive, building, cement, steel, transportation, and utilities sectors).

Mounting cyber attack risks from geopolitical tensions and increasing digitalization

Risk level Very low Moderate **Elevated** High Very high **Risk trend** Improving Unchanged **Worsening**

The pace of digitalization in the global economy exposes corporates and countries to mounting cyber risks—where targets can include anything from utilities to insurers to government agencies—weigh on credit quality, result in substantial monetary losses, and undermine confidence in key institutions and infrastructure. Geopolitical tensions raise the prospect of major cyber attacks. Russia’s use of cyber attacks during its military conflict with Ukraine proves how these moves are becoming a more prevalent means of weaponry, with systemic implications.

Source: S&P Global Ratings.

* **Risk levels** may be classified as very low, moderate, elevated, high, or very high. They are evaluated by considering both the likelihood and systemic impact of such an event occurring over the next one to two years. Typically, these risks are not factored into our base case rating assumptions unless the risk level is very high.

** **Risk trend** reflects our current view about whether the risk level could increase or decrease over the next 12 months.

Macroeconomic Outlook

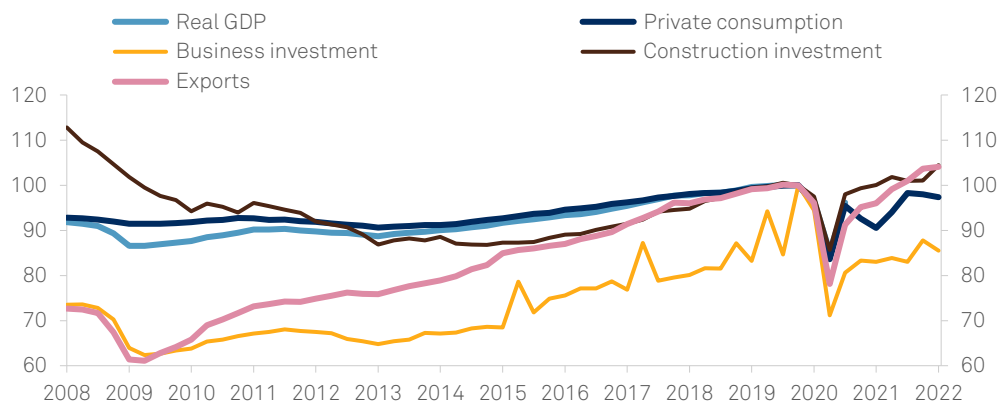
War, inflation, and a disorderly market response to monetary policy normalization test the resilience of the European economy

Eurozone

- The eurozone economy may look like it has been defying gravity. GDP expanded more than expected and above potential by a quarterly 0.6% in first-quarter 2022, with 1 million jobs being added. Job openings are reaching new highs, while the unemployment rate is already at a multidecade low, suggesting the labor market has yet to peak. Services are benefiting from the end of COVID-19 restrictions, and a normal tourist season is taking shape for the first time in three years. Full order books are keeping the manufacturing sector busy and capacity utilization is above average. In the first quarter, the European economy was driven by inventory rebuilding, foreign trade, and construction.
- That said, consumer spending fell in the quarter due to soaring energy and food prices that ate into purchasing power. Investment remains below its prepandemic level and path. The Russia-Ukraine war and high inflation shattered consumer confidence. Although a decline in the savings rate kept consumer spending from falling further the exceptional level of savings has not yet been exhausted, the rapid correction in asset prices is contributing to its erosion. On the supply side, the lockdowns in China and Russia-Ukraine war tightened bottlenecks, posing problems for a European industry already dealing with the numerous backlogs. Leading indicators suggest that growth momentum is waning. GDP in the second quarter might come in at the low range of expectations, which does not rule out a slight contraction.

Chart 9

Eurozone GDP And Components



Q4-2019=100. Source: Refinitiv, S&P Global Ratings

- Not only is inflation rising rapidly, it is also becoming more widespread. Core inflation reached 3.8% in May, 1.5 percentage points higher than at the beginning of the year, while headline inflation climbed to 8.1%. Unit labor costs remain subdued, admittedly, at 2% in the first quarter on slightly accelerating wages, but energy and food prices remaining elevated for longer undermine the prospect of a rapid decline in inflation. Uncertainty surrounding our projections remains exceptionally high, but we no longer expect inflation to fall below 3% next year and below 2% in 2024. The ECB has come to a similar conclusion and has set its monetary policy on a normalization path. The central bank will end net bond purchases on July 1 and has committed to a series of interest rate hikes, beginning the same month. We expect the terminal rate in this series to be around 1.5%, which is in line with the median of the range of the ECB's current estimate of the neutral rate. With the output gap remaining negative into next year and inflation decelerating, the ECB is, for now, unlikely to take a restrictive stance on monetary policy. Unlike the Fed and Bank of England, the ECB has not committed to normalizing its balance sheet soon. Instead, the ECB is looking for new policy instruments to prevent financial fragmentation during interest rate normalization.

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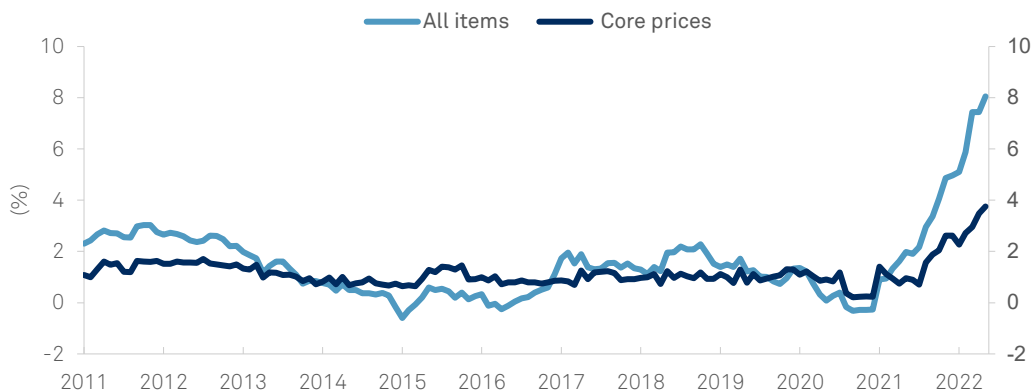
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Chart 10

Eurozone HICP Inflation (percentage change, year-on-year)

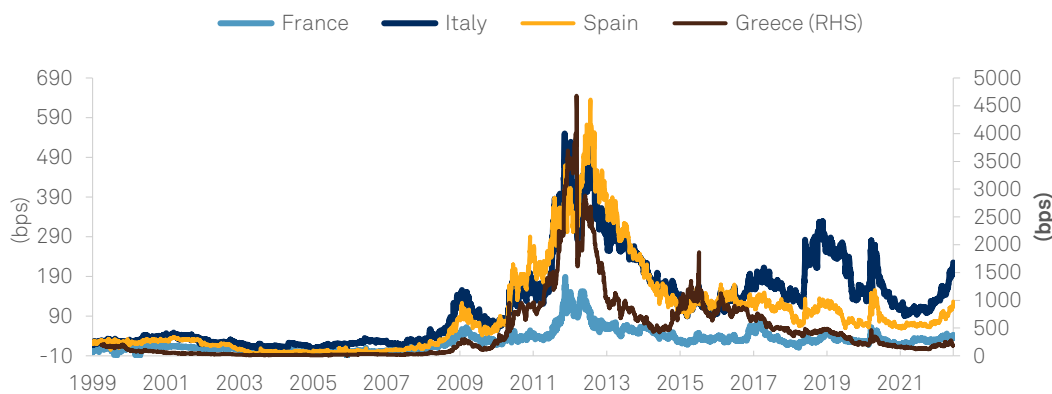


Source: Refinitiv, S&P Global Ratings

- Faster monetary policy normalization around the globe led to a disorderly repricing in financial assets. Money markets currently doubt that the neutral rate will be the terminal rate. As a result, German 10-year yields rose even more than U.S. Treasuries, hitting 1.9% mid-June versus 1% in May, and spreads of European government bonds over Germany have widened. Long-term interest rates could possibly remain less negative in real terms than previously thought and market volatility weigh on investment decisions.

Chart 11

EGB 10-year Yields – Spread vs. Germany



Source: Refinitiv, S&P Global Ratings

- Bottom line: While GDP surprised on upside in the first quarter, the ongoing Russia-Ukraine conflict, higher inflation, and the market turmoil led us to revise downward our macroeconomic outlook once again. In particular, the last development will depress growth next year, for which we now pencil in less investment and less use of excess savings. We expect GDP to average 2.6% in 2022 (not much more than the statistical carryover for this year) and 1.9% in 2023. This is down 0.1 and 0.3 percentage points, respectively, from our previous forecasting exercise.

Key assumptions

- The Russia-Ukraine conflict is unlikely to end this year, but we continue to think it will not extend to other countries nor involve unconventional weapons.
- Russian exports of gas to the EU will not be cut off suddenly.
- Commodities prices, especially oil, should ease gradually once the conflict stops.
- Supply chain issues are likely to ease gradually.

Key risks

- A longer, more intense Russia-Ukraine conflict that extends to other countries could lead us to reassess our baseline scenario, especially via the channels of confidence, trade, and supply chains.
- A sudden cut-off in Russian export of gas to Europe could destabilize European production and bring higher inflation.
- A continuation of market turmoil could halt investment decisions.
- Excessive financial fragmentation in the eurozone could depress the growth outlook.

What to look for over the next quarter

- Any development in the conflict between Russia and Ukraine. We're watching: Commodities prices and global supply chains. Consumer behavior (in the form of the savings rate) in the context of low confidence, high inflation, and rapid rising yields. A possible resurgence of COVID-19 in Europe, even if the virus has lost its grip on the economy.

U.K.

- Inflation at multidecade highs will depress household spending power, weaken spending, and ultimately contribute to contribute to a mild contraction in GDP over the second and third quarters this year (a technical recession), and weak growth next year.
- But there is more: To bring inflation back down to its 2% target, the BoE will also continue raising its policy rate into early next year, reaching 2%, before pausing for a few quarters. While policy tightening is necessary and even beneficial to the growth outlook in the next few years, it comes at a cost now: Higher funding costs will add to the downward pressure, mainly via weaker investment, but also by reducing household wealth. These effects are compounded by already tighter market conditions both in the U.K. and globally.
- Some downside risks to our earlier forecast have materialized. Specifically, a resolution of the Russia-Ukraine war is not in sight and global energy market repercussions are not abating. Oil prices have remained elevated, European gas prices are extremely volatile at extraordinarily high levels, and global prices for food staples could rise further. While the latter still feeds through global and domestic supply chains, inflation is unlikely to come down quickly before late next year, dampening economic activity for longer than previously expected.
- In view of these recent developments and particularly the outlook for inflation, we have revised down our outlook for the U.K. and now expect GDP growth of 3.2% for this year, 1% in 2023, and 1.7% and 2% in 2024 and 2025, respectively. The GDP growth of 3.2% for this year is dominated by a carry-over from last year, worth 2.8% and the remainder is due to a strong first quarter; we expect underlying anemic growth for the rest of the year.

Financing Conditions

Inflection Or Affliction Point, As Financing Costs Rise

- **A growing wedge between core and periphery yields has led to unexpected ECB intervention.** Persistent inflation and rising commodity costs are informing the pace of monetary policy tightening and leading to a consequential reduction in economic growth forecasts. A sharp rise in periphery yields has forced the ECB to react to counter fragmentation concerns, although the details of how such an antifracturing tool might work remain uncertain. Despite recent tightening, German 10-year yields are at their highest since the first half of 2014, and the trend in weaker periphery economies is even more pronounced. Yields on 10-year Italian BTPs are up around 220 bps this year (as of June 23), and the gap with German Bunds has widened, and is above 190 bps (as of June 23).
- **Credit risk premiums for both investment-grade and speculative-grade spreads are rising sharply as investors brace for more volatility and uncertainty.** Pricing of credit risk—steadily increasing for most of 2022—accelerated steeply in June as investors wrestle with the potential economic fallout. The cost of credit protection has been rising sharply from June while loan prices dropped markedly. Speculative-grade spreads, which tightened in May, have risen steeply past 550 bps (as of June 23) and are now at the highest point since the pandemic-induced peak in the first half of 2020. Investment-grade debt is also affected; spreads have doubled so far this year, climbing above 170 bps (as of June 23). Clearly, investors continue to refocus on credit risk after a period where abundant liquidity forced investors to go longer or lower in search of yield. This has resulted in rising spreads and rising yields, which ultimately means higher financing costs.

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Chart 12

Issuers Rated 'B-' And Below: Debt Maturing Through 2023

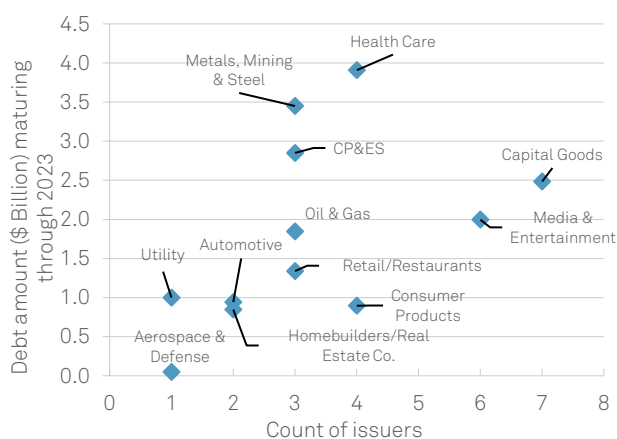


Chart 13

European Investment Grade And Speculative Grade Spreads

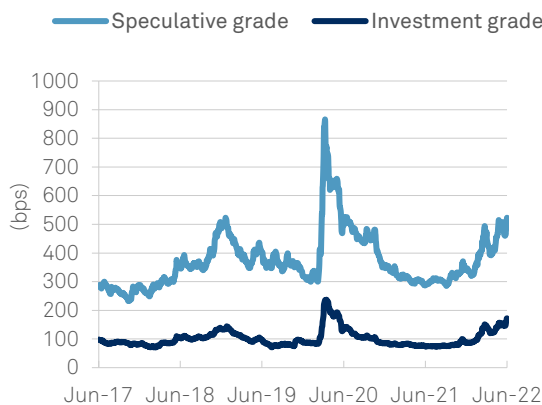


Chart shows number of nonfinancial issuers rated 'B-' and lower from EMEA with debt maturing from July 1, 2022, through Dec. 31, 2023, and the maturing debt amount. Debt includes bonds, notes, and term loans; excludes revolvers. CP&ES--Chemicals, packaging, and environmental services. Source: S&P Global Ratings.

Speculative grade: Option-Adjusted Spread (OAS) of the ICE BofA Euro High Yield Index. Investment grade: S&P Eurozone Investment Grade Bond Index (OAS). Data shown from June 15, 2017, to June 15, 2022. Source: S&P Global Ratings, Federal Reserve Bank of St. Louis.

- **Despite the continued collapse in issuance, near-term refinancing risk looks manageable.** Speculative-grade bonds continue to bear the brunt of the issuance drought, with issuance down by close to 75% year to date. After a strong start, loans have fared little better, even though their floating rates provide some comfort in a time of higher inflation. Current bid prices are unlikely to result in a significant restart of primary markets in the near term. Muted primary markets clearly increase the pressure on speculative-grade companies requiring access, but for now it seems that refinancing risk will fall largely on investment-grade issuers. Only 5% of nonfinancial corporate issuers rated 'B-' or lower that we rate across EMEA face debt maturing before the second half of 2022, and only 22% before end-2023. From that perspective, refinancing risk is limited, at least in the near term. Still, the media and entertainment sector and the capital products sector account for the largest number of issuers rated 'B-' or lower with debt maturing between now and the end of 2023.
- **A mixed picture for rating performance.** On the surface, rating performance year to date looks benign, with five defaults (less than half the 2021 total) and a trailing 12-month default rate of

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less than 1%. Cumulative rating actions to date in 2022 have also been net positive while negative bias – an indicator of future downward rating actions – are well below long-term averages. However, the rating profile remains far weaker than before the pandemic with a greater number of speculative-grade issuers, a greater number of speculative-grade issuers rated 'B-' (around 30%), while the largest share of 'CCC' issuers are concentrated in the media and entertainment sector. Downgrades increased and upgrades decreased in May, while negative bias picked up across the retail and restaurants sector. As inflation and the impact of monetary policy tightening increasingly weigh on consumer confidence, we can expect consumer-focused sectors to face the strongest rating headwinds.

Financial Institutions

- Our outlook bias remains stable, but downside risks have increased as the Russia-Ukraine conflict persists. Lower economic growth, tighter funding conditions, and high, more persistent inflation are clear headwinds for banks' asset quality, business prospects, and cost management.
- On the other hand, monetary policy tightening will give upside to banks' net interest income and thus a larger buffer to accommodate potentially higher credit and operating costs.
- Banking systems in Central and Eastern Europe and the Baltics are relatively more vulnerable to second-round effects from the Russia-Ukraine conflict. Within Western Europe, the German, Italian, and Cypriot banking systems are the most affected due to these countries' reliance on Russian gas or higher exposure to more affected corporate sectors.
- Key risks ahead include much lower or negative economic growth, potentially caused by a hard stop of gas supply from Russia, persistently high inflation, or ongoing market disruption that further tightens funding conditions.

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Key Developments

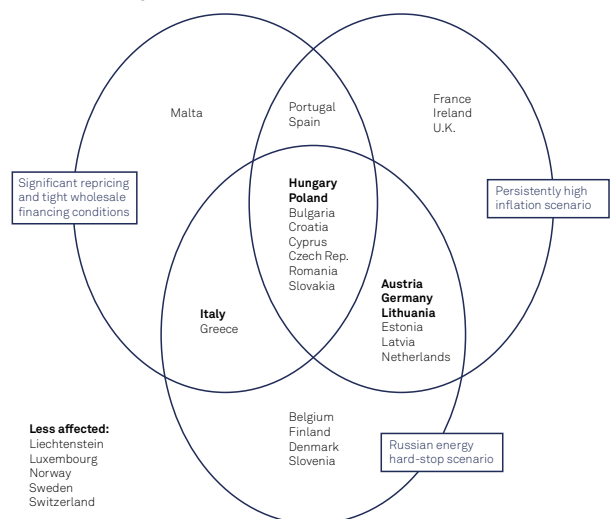
- **Monetary policy normalization will support European banks' earnings, but more clearly in 2023 than in 2022.** There is already evidence of widening margins and overall improving profits in the U.K. and Central and Eastern Europe (CEE) countries, where rates started to move earlier. And we expect banks in the eurozone to follow suit. Ahead of the ECB's announced intention to raise policy rates from July, market rates—which are the ones used to price loans—widened, with both the one-year and six-month Euribor moving to positive territory. Still, the margin benefit will be a greater feature next year rather than now, as fully repricing floating-rate exposures will take some time, and banks lose (from now) the 50 bps additional funding cost benefit on their TLTRO (targeted longer-term refinancing operation) borrowings. Regulatory disclosures point to an average 14% increase of eurozone banks' net interest income in the event of a parallel 200 bps upward move in interest rates (see chart 15); all else being equal this would lead to a 26% increase in pretax profit. Banks with a higher share of floating assets (or assets hedged to floating rates) and a higher share of non-price-sensitive retail deposits will benefit the most.
- **Lower economic growth prospects, market turbulence, and inflationary pressures will eat some of the benefits of wider interest margins.** Business activity will slow as the economy decelerates, and certain business lines (asset management, debt and equity underwriting for investment banks) will take a hit from increased market volatility and uncertainty. High and persistent inflation will make it difficult for banks to keep costs under control, which has been a strategic priority over the past few years to improve efficiency. Regarding asset quality, we could still see the emergence of problem loans from the pandemic as well as additional problem loans in industries or companies more directly affected by higher energy and commodity prices, with likely more limited ability to pass on higher costs through prices, or with more stretched debt and affordability metrics. Still, we don't expect a material impact for banks, with credit costs somewhat exceeding our previous expectations, but remaining manageable.
- **The abrupt repricing of risk in recent weeks will weaken banks' capital ratios through fair-value adjustments of their sovereign portfolios.** Banks in the periphery could prove more vulnerable as yields on those sovereigns have widened more significantly than those in core Europe. Overall, we think the impact will be manageable for banks' capitalization, which is only recently declining from peak levels. Limited market funding needs will prevent a contagion through higher funding costs, though there is always a risk that higher yields on sovereign debt accelerate the repricing of domestic bank deposits.
- **European banks' recognized write-downs on Russian exposures, to different degrees.** French Societe Generale was the first bank to exit the Russian market in an orderly manner, selling its Russian subsidiary, in a transaction that will ultimately cost the bank €2 billion (an affordable 20 bps of common equity tier 1 capital). Italy's UniCredit has not found an exit strategy yet, but it recorded €1.5 billion of credit costs in the first quarter to cover the potential capital hit of exiting Russia as well as potential losses on direct exposures. Conversely, while Raiffeisen and OTP Bank have increased credit loss provisions at their Russian subsidiaries, they have not yet provisioned for losses on their equity investments in these subsidiaries. We think such losses are inevitable at some point. Raiffeisen and OTP also have operations in Ukraine, which adds further pressure. Large European banks (ING, CASA, and BNP, for example) have also set aside

provisions to cover for their Russian cross-border exposures, although coverage achieved differs from bank to bank.

- **We lowered our ratings on one European global systemically important bank: Credit Suisse.** The downgrade was driven by an accumulation of risk events (exposure to collapsed Archegos, Greensill, and other smaller cases), which evidenced a high risk appetite and control deficiencies.
- **In some CEE countries, Hungary and Poland in particular, authorities just announced new taxes on banks.** The goal seems to be that banks allocate some of the higher profits coming from rapidly rising interest rates to ultimately support borrowers. Banks look able to absorb the additional charges without reducing their financial strength. So, by itself these measures are unlikely to lead to negative rating actions. Nevertheless, their impact could be higher if economic conditions materially weaken and banks face higher credit costs.

Chart 14

European Banking Systems Have Differing Degrees Of Vulnerability To Downside Risks



Banking systems shown in bold above would be the most sensitive in their category. Source: S&P Global Ratings

Chart 15

European Banks Earnings Will Benefit From Higher Interest Rates

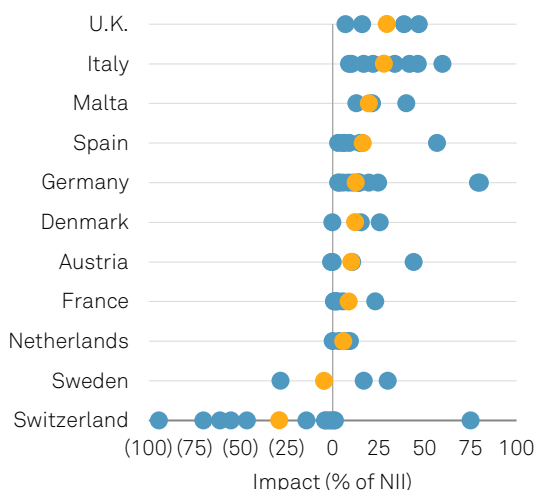


Chart shows the impact of a "parallel up" (200 basis points) scenario on large banks' net interest income across countries. The gold dots indicate weighted average values, the blue dots indicate individual bank values. Source: S&P Global Ratings

Key Risks

- **A shock to economic growth**, such as one from a sudden stop of Russian gas exports to Europe, which in turn would take a toll on confidence. In this scenario, the quality of banks' loan books will suffer, as well as banks' business and profitability prospects.
- **Inflation remaining persistently high**, putting pressure on corporates and households' financial conditions, hampering banks' asset quality, and making it harder for banks' management teams to keep operational expenses under control.
- **Persistence of market turbulence and restrictive financing conditions.** Riskier borrowers would suffer from higher funding costs and limited access to financing, which would ultimately result in higher credit losses for banks. Banks would also be exposed to higher mark-to-market losses and weaker earnings from market-related business, like asset management.
- **Potential correction of prices in some property markets**, in response to significant interest rate rises, tighter underwriting from banks' reduced risk appetite, and weaker confidence.
- **Banks' failure to deliver commercially and operationally resilient business models.** In an environment of rising rates and thus earnings growth, some banks may feel less pressured to tackle their inefficiencies. Additionally, banks' digital transformation may lag behind clients' rapidly changing behaviors. Coupled with increased competition from digitally advanced new entrants, this may hurt banks' franchises.
- **Widespread, high-impact cyber attacks.**

Nonfinancial Corporates

- Rises in input costs, including raw materials and energy, and slower economic growth are negative factors for most European corporates, most particularly those that have less ability to pass through higher costs to their customers in a timely manner.
- Many companies entered 2022 with solid credit ratios. This provides a buffer against margin pressures. We see higher risks in the lower end of the rating spectrum due to the generally greater difficulty in passing on cost increases and weaker financial profiles.
- Clearly, commodity companies are the main beneficiaries from ongoing elevated commodity prices, with oil companies benefiting the most.
- Financing conditions have tightened significantly. Investors are being more selective and reassessing risks. Financing costs are at their highest for two years and access to refinancing is no longer available to all issuers. In April 2022, after eight months without any default in our rated portfolio (excluding Russian and Ukrainian issuers), two companies defaulted in Europe.

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Key Developments

- **In the first five months of 2022, excluding rating actions on Russian and Ukrainian entities, EMEA nonfinancial corporates saw more upgrades than downgrades.** This largely reflected the structural improvement in credit metrics achieved by some companies in 2021, thanks to the strong rebound in demand amid few pandemic worries, which also made it possible to more easily pass through higher input costs to customers.

Chart 16

Upgrades outpaced downgrades in the first five months 2022

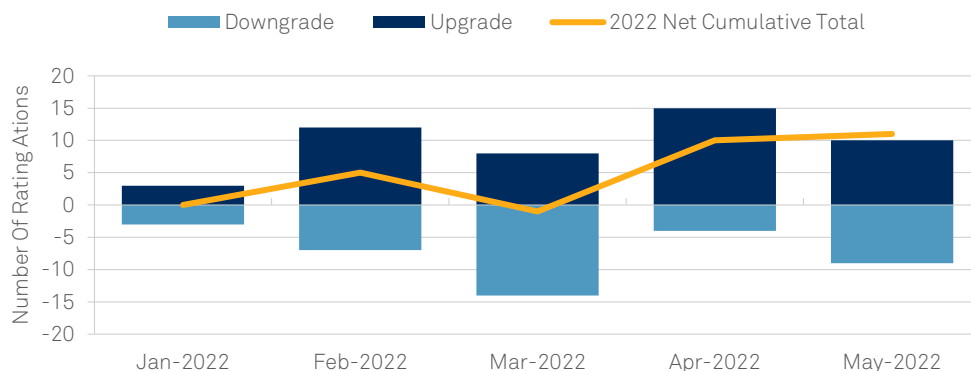


Chart excludes issuers domiciled in Russia or Ukraine. Source: S&P Global Ratings

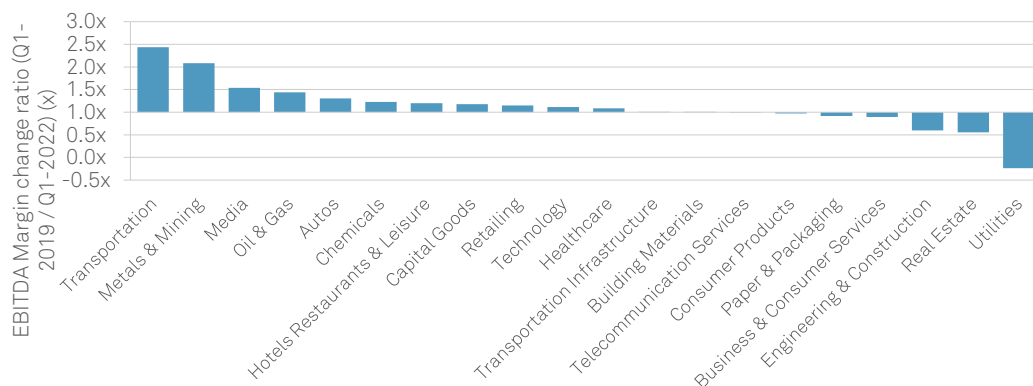
- For the rest of this year, while there may be some positive rating actions, more likely in those sectors benefiting from current conditions—such as the energy, commodities, and some raw material sectors—that is unlikely to be the case more broadly. Many nonfinancial corporate sectors entered into 2022 with solid credit ratios, providing some ratings headroom against the current backdrop of rising inflation and slower economic growth. But we expect that headroom will shrink over this year. First-quarter 2022 corporate results already showed that on average gross margins eroded compared with first-quarter 2021.
- A number of divergent factors pushed performances in different directions. Supply bottlenecks eased somewhat, reducing pressure on costs, while energy and raw material prices continued to grow. The full impact of these factors will become more visible later in the year, given that many companies hedged part of their raw material needs, and many utilities can apply energy cost increases only at given maturities.
- At the same time, the onset of the Russia-Ukraine conflict dented corporates' confidence and their assessment of future growth prospects. Consumer demand has remained robust in sectors most hit by the pandemic, such as leisure, media, and transportation. In Europe, hotel and flight reservations for summer vacations picked up as consumers tapped some of their higher stock of savings. However, the surge of inflation is now hitting both the consumer and the business sector and is among the factors that is fostering more pessimistic expectations for the future.

Credit Conditions Europe Q3 2022: Pain On The Horizon

- The significant reduction in Russian gas supply to Europe started in the first quarter and accelerated mid-June, adding to inflationary pressure and confirming our expectation that European gas and power prices are going to stay elevated over the next 2-3 years at least. Further escalation of geopolitical tensions could prompt further cuts in the Russian gas supply, further boosting energy prices. In our view, it would take further negative factors to prompt forced supply interruptions to European customers, depending in the level the E.U. wants to maintain gas stocks.

Chart 17

European Corporates Change in EBITDA Margin, Q1-2019 to Q2-2022

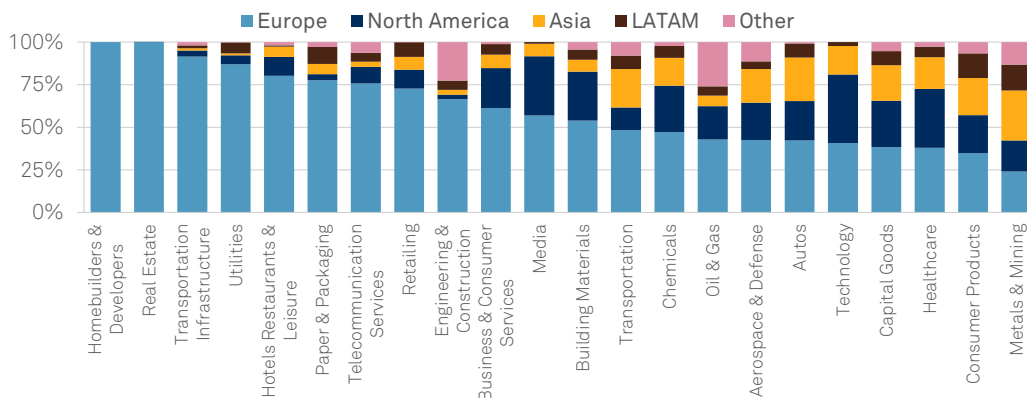


Sample of European companies which reported Q1 figures by May 31, 2022 (about 25% of European rated universe). A change in the ratio of 2 times indicates a doubling of the EBITDA margin between Q1-2019 and Q1-2022 Source: S&P Capital IQ

- One effect of tighter monetary policy in the U.S. relative to the EU is the depreciation of the euro to the dollar. This can be positive for European corporate revenues. In fact, with sizable differences by industry, many European companies are exporters, so their revenues should benefit from the weaker exchange rate, even if part of that positive effect will be offset by the higher dollar-denominated input costs.

Chart 18

Geographical Breakdown Of European Corporates' Revenues



Data for Fiscal Year 2021, expressed in USD converted at historical rates. Sample European companies which had reported full year 2021 results as of May 31, 2022. Source: S&P Capital IQ, S&P Global Ratings.

Key Risks

- Notwithstanding the solid results reported by several companies for 2021 and the improvements in their credit ratios, we note that the average quality of the portfolio is still weaker than before the pandemic in terms of rating quality. The proportion of ratings in the 'B-' and 'CCC' categories with a negative outlook or on CreditWatch negative at the end of May 2022 was still about 14% above the five-year historical average, with the media and entertainment, consumer products and services sectors having the highest representation. We see companies in the lower end of ratings scale as most exposed to the risk coming from the combined effects of higher costs and

Credit Conditions Europe Q3 2022: Pain On The Horizon

lower demand, because their often lower ability to pass cost increases in a timely manner. Besides, their capacity to adapt products and services to the changes in demand is limited by narrower ranges and tighter financial headroom.

- In April and May 2022 in EMEA there were three defaults in our rated portfolio, excluding Russian and Ukrainian entities. Between August 2021 and March 2022, there were no defaults among rated corporates in EMEA. This was unusual, reflecting extremely supportive conditions in the financial markets. Now, that the picture has changed, we assume that defaults will return near to the historical average. We are expecting a 3% default rate by March 2023.
- While financing conditions are tightening, we note that several companies raised a significant amount of debt in the past two years at very favorable conditions. What this means is that they have several years before a refinancing of the outstanding debt is needed. Consequently, it will likely take years for rising interest rates to meaningfully impact companies' debt burden. In Europe, 53% of rated debt was issued before 2019. This metric is lower—at 40%— for speculative-grade companies, which have largely taken advantage of the excess liquidity in the market since the pandemic. This situation does not cover the new financing needs that are exposed to new and less favorable market conditions.

Sovereigns

- After posting 5.4% growth in 2021, the eurozone now faces a complicated scenario: volatile demand and supply shocks, the ongoing Ukraine conflict, and deglobalization. These are dragging on confidence and productivity, pushing up inflation (and inflationary expectations) and increasing developed sovereigns' vulnerability to interest rate shocks.
- Our positive outlooks for eurozone sovereigns still exceed negative outlooks by 3 to 1, but that ratio has been declining. The decision by EU members to mutualize the cost of the pandemic fallout, by mandating the EU to finance Next Generation EU investment plans of 11% of GDP for Italy, and 6% of GDP (all grants) for Spain, looks to put a floor under growth this year and next. Rising spending on defense and energy subsidies will slow, but not reverse, budgetary consolidation from 2022 through 2026, in our view.
- Most eurozone sovereigns entered 2022 with long-dated debt profiles, near historical lows on interest expenditure to GDP, and large cash buffers (notably for Greece and Italy). The change in financing costs so far this year has been abrupt, but largely reflects governments' budgetary assumptions about the cost of debt for 2023.
- We estimate that a further rise in yields of 300 bps from current levels over three years – which is not our base case - would push the cost of debt for most developed sovereigns back to 2015 levels. The fiscal cost from this shock amounts to about 1% of GDP, which would be material but manageable.
- For Italy and Spain, given starting points for their refinancing rates, the same 300 bps three-year shock would push interest to GDP to above 2012 levels of 5.2% of GDP for Italy and 3.0% of GDP for Spain. This ignores the second-round effects on growth, which matter the most.
- We see the likelihood of such a shock as remote, given the ECB is committed to deliver a new antifragmentation instrument and has highlighted the flexibility it possesses to reinvest redemptions under its PEPP (pandemic emergency purchase programme) purchases as it sees fit.

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Key Developments

A year ago, we were confident that eurozone sovereigns would be able to digest the first-round effects of even a 300 bps rise in refinancing rates on their public finances. Back then our assessment was that acceptable productivity trends had survived the worst of the pandemic largely intact, particularly in the developed world. Since then, Russia invaded Ukraine, oil prices doubled, Europe is facing a further gas supply squeeze, the Fed has raised its funds rate by 150 bps, we revised down our forecast for China's 2022 GDP growth to the lowest in decades, and revised up our inflation forecasts for the U.S., eurozone, and the U.K. to 40-year highs.

All in all, 2022 is already proving to be challenging for developed sovereigns, and 2023 looks to be even more so as real interest rates normalize further and the prolongation of the Russia-Ukraine conflict weighs on confidence and growth. Meanwhile, supply bottlenecks—particularly those in the energy sector—are keeping import and commodity prices high.

The ECB will have to walk a very thin line between pursuing its medium-term inflation target of 2% and launching new programs aimed at fighting divergence in eurozone yield curves. As in the past, the task of the ECB is complicated by the absence of sufficient supranational assets to purchase in order to conduct monetary operations, and the consequent need to hold national assets. We think it is going to be tricky to navigate the eurozone economy down from high levels of nominal GDP without triggering more volatile real GDP projections, given the conflict and the unpredictability of household and corporate behavior toward what appears to be the tail end of a global pandemic.

By our calculations, applying a shock scenario of an additional 300 bps increase (from current levels) over three years in the cost of new debt for most developed sovereigns (for example, France) would mean interest costs as proportion of GDP returning to 2015 levels, rising by about 1% of GDP. That is a material but, in our opinion, manageable increase.

For Italy, however, that shock would lead, according to our calculations, to interest costs to GDP rising above 2012 levels of 5.2% of GDP. For Spain, interest payments to GDP would reach their 2012 level of 3.5% of GDP by 2025.

That said, we see that level of additional spread widening as a highly unlikely development, given the ECB's commitment to launch a new antifragmentation instrument to keep real interest rates broadly level across the eurozone.

In the background, there are still multiple supports for the eurozone economy. In July 2020, the European Council mandated the EU to raise funds in financial markets to back a €750 billion Next Generation EU Fund to support those governments hit hardest by the global pandemic. These funds are conditioned on the implementation of structural reforms and are coming into eurozone economies between now and 2026. Eurozone banks and households have considerably strengthened their balance sheets over the last decade. A weaker euro has also led to solid export performance so far this year.

Fiscal buffers also exist. For example, the Italian Treasury benefits from several factors. Its cash and liquidity position as of end-May exceeds €80 billion, or 4.2% of GDP, and it has already raised close to all of its gross borrowing needs for 2022. Moreover, because the Italian yield curve is upward sloping, authorities could temporarily issue shorter-dated debt to avoid locking in higher financing costs, at least until the ECB launches a new program aimed at reversing monetary fragmentation. Other eurozone sovereigns such as Greece, Portugal, and Spain have similar advantages.

Most eurozone economies entered 2022 with significant external trade and services surpluses, relatively low private-sector debt (particularly Italy), and National Recovery Plans that target pro-growth reforms. Of course, that doesn't rule out additional inflationary shocks and a worsening of short-term growth prospects as financial conditions tighten. Moving forward, if the Russia-Ukraine conflict persists and growth decelerates more than we forecast, the pace of eurozone reforms will be an area to monitor. The EU is a single market for labor, but with 27 labor codes all codified at the national level. Licensing stipulations vary from country to country and are generally anticompetitive in their consequences. One way to unlock growth would be to match the single market for labor with a single EU labor code. However, the political direction is currently more toward fragmentation at the national and subnational level.

International Public Finance

- High inflation is contributing to a strong budget revenue performance for European local and regional governments (LRG) in the short term. Due to massive financial support from central governments during the pandemic, they face a potential economic slowdown from a position of relative financial strength.
- In contrast, public-sector enterprises with limited revenue flexibility will suffer more from rising inflation. Their financial performance will drop below their earlier plans for 2022, while their ability to substantially raise fees for 2023 could be difficult to achieve amid a much higher cost of living for their publics.

Primary contact

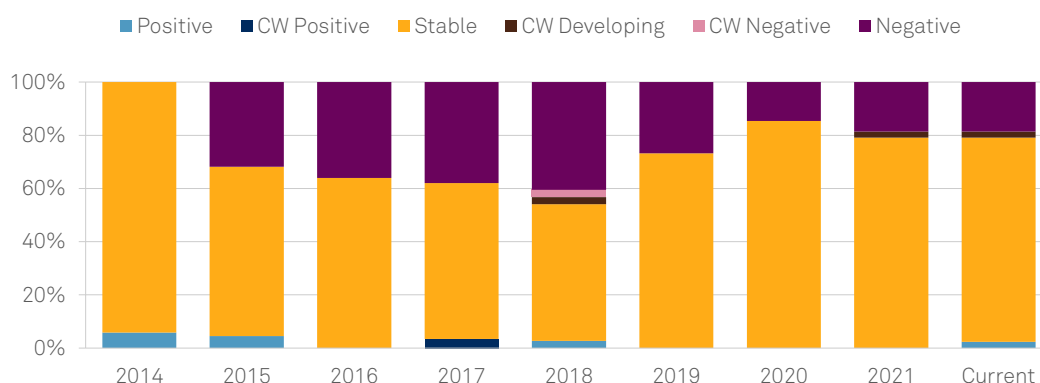
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Key Developments

- U.K. social housing providers are still the primary asset class in European public finance that are experiencing downward ratings pressure (see chart 19). Rising inflation amplifies their need to increase investments in existing stock and deliver new units due to consistently high demand. The maximum rent increase for this financial year (4.1%) falls well short of the increase in consumer prices. Unless the providers reduce their development plans dramatically, their debt burden will continue to rise amid shrinking performance.
- Rated cities in CEE are suffering from the effects of trade disruption from the Russia-Ukraine conflict and the related influx of refugees, as well as rising costs for their municipal companies. Still, we believe they have sufficient financial strength to withstand potential further increases in costs and lost revenues. We assume that additional costs won't exceed 20% of revenues in 2022, which could be partially compensated by central governments or the EU. Even if that is not the case, the resulting additional debt burden would still be in line with our current ratings.
- We observe a strong tailwind for the credit quality of Swiss cantons. They have been very resilient since the beginning of pandemic and are set to continue deleveraging over the medium term. The reliance of the country's energy system on hydropower and alternative energy sources make the country relatively immune to the current increase in fossil fuel prices.

Chart 19

Ratings On The U.K. Social Housing Sector Continue To Demonstrate Solid Negative Bias



Source: S&P Global Ratings.

Key Risks

- Evolution of the Russia-Ukraine conflict, leading to further disruptions in European trade, sluggish economic growth, and elevated inflation for longer.
- A fall in the ability or appetite of central governments to provide financial assistance to LRGs and public-sector enterprises in the face of other pressing spending needs, including, for example, support for those suffering from steep rises in the cost of living, an increase in defense-related spending, or higher interest costs.
- Ability of public-sector enterprises to raise fees in line with inflation to cover rising costs.

Insurance

- First-quarter operating results from European insurers have been solid. Capital market volatility has been mirrored in mark-to-market asset valuations, which has weakened investment results. Reported asset quality remains very high and we expect impairments to remain muted.
- Europe-based reinsurers continued to feel the impact from COVID-19 in life reinsurance. In addition, storms in Europe, quakes in Japan, Australian flooding, and Texas wildfires represented a weak start to the year. However, we are somewhat positive about 2022 renewals.
- Positive effects from rising interest rates—enabling a widening of investment margins over the long run for life insurers—also dampens the negative impact from inflation for non-life. Life insurers benefit from stronger capital ratios, while non-life insurers face the need to raise rates.
- Following the Russian invasion of Ukraine, more than 500 aircraft have been grounded in Russia. We do not see any other material insurance exposure. However, the conflict might lead to material insurance claims in specialty lines like political risk, war, all-risk cover, aviation, but claims settlement may take a long time considering potential disputes regarding coverage.

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Key Developments

- Despite external factors leading to capital market volatility, the European insurance sector is holding up well. Besides stable insurance margins, we haven't observed a pickup in competition alongside higher inflation. We believe higher inflation will drive higher policy rates. With materially higher reinvestment rates, insurers might have an alternative to bringing capital to work in case specific lines face eroding margins.
- We continue to see a capital surplus above levels required for current ratings as a key ratings strength. Where buffers will be required for higher investment default rates and volatile capital markets, European insurers display robust capital adequacy with a redundancy at the 'AA' rating level as per our risk-based capital model. Rising interest rates benefit life insurers' regulatory ratios, and our measure of their capital surplus over the medium term.
- We continue to have a negative view about prospects for the reinsurance sector, which hasn't met its cost of capital for a while. Large losses will take time to hit reinsurers' bottom line, but we believe that ongoing large claims events will need to be met with adequate rate rises.

Chart 20
Rating Distribution

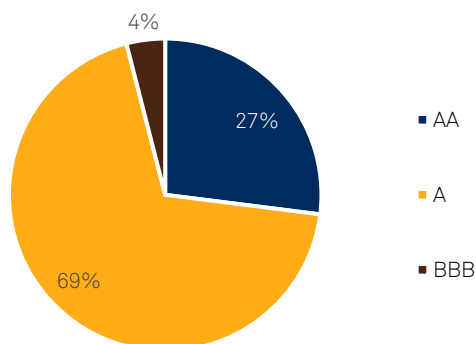
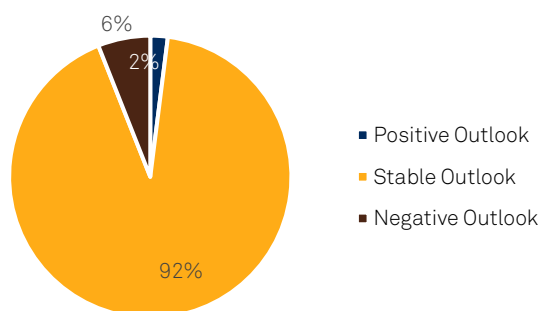


Chart 21
Outlook Distribution



Data as of June 8, 2022. Source: S&P Global Ratings.

Data as of June 8, 2022. Source: S&P Global Ratings.

Key Risks

- Capital market volatility due to the Russia-Ukraine conflict and China supply chain issues.
- Inflation remaining higher for longer, impacting non-life insurance profitability and questioning the adequacy of reserving for long-tail lines.
- Although we see steadily increasing long-term interest rates as beneficial to life insurers, massive spikes might evaporate unrealized gains on bonds and increase the risk of lapses.
- Though not our base case, reinsurance rate increases might fail to fully reflect claims and inflation trends.

Structured Finance

- The rising cost of living could affect the ability of consumers backing European structured finance transactions to maintain their debt repayments.
- We expect mortgage borrowers' sensitivity to the current stress in different markets to depend on the prevalence of floating-rate loans and the level of household indebtedness.
- Structured finance ratings have historically been most correlated with changes in the unemployment rate, but we expect unemployment to remain flat.
- We count downgrades on only 1.1% of European structured finance ratings over the past 12 months.

Primary contact

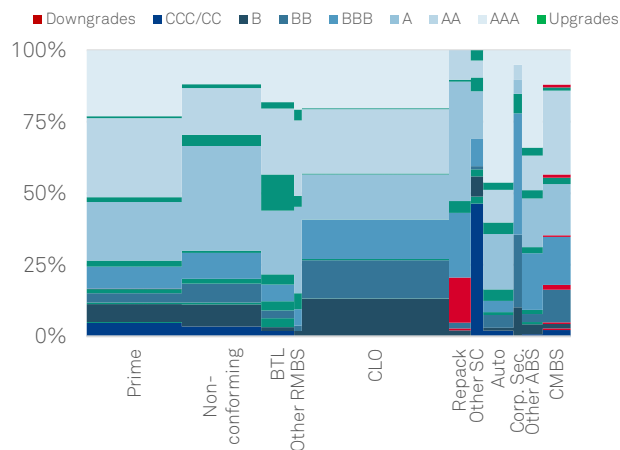
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Key Developments

Across European structured finance, most recent rating actions have been upgrades, and we lowered only 1.1% of our ratings in the sector in the 12 months to end-May 2022 (see chart 22). Weakness has mostly been confined to the repack sector, where several downgrades in January 2022 were correlated and due to a rating action on a single underlying entity. There have been very few rating actions on European leveraged loan collateralized loan obligations (CLOs), although this is the structured finance sector that is most exposed to the ongoing Russia-Ukraine conflict.

Chart 22

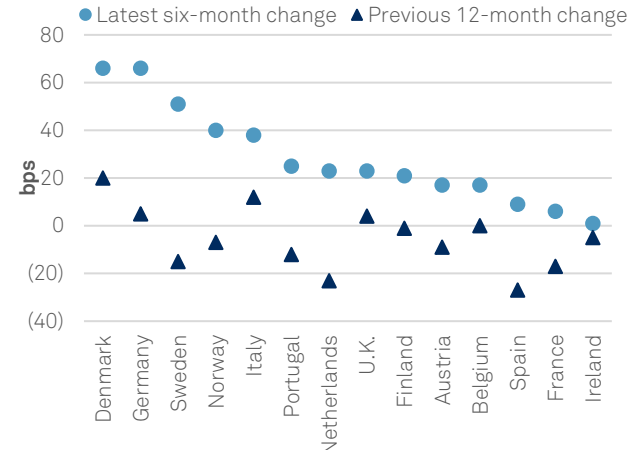
European Structured Finance Ratings Heatmap



BTL—Buy-to-let. SC—Structured credit. Based on cumulative count of rating actions between June 1, 2021, and May 31, 2022. Source: S&P Global Ratings.

Chart 23

Change In Mortgage Rates On New Lending



Bps—Basis points. As of April 2022. Source: European Central Bank, Bank of England, S&P Global Ratings.

Key Risks

The current cost-of-living shock is potentially compromising the ability of consumers backing European structured finance transactions to stay current on their debt repayments, especially for residential mortgage loans. As central banks have begun to signal tighter monetary policy and market interest rate benchmarks have risen, mortgage rates have begun to follow (see chart 23).

However, different covered bond and residential mortgage-backed securities (RMBS) markets could differ substantially in their sensitivity to rising inflation and interest rates, as well as the degree of stress they experience. For example, consumer prices have risen much more in the Netherlands than in France, partly linked to differing household dependence on the worst-affected energy commodities, such as oil and gas.

Borrowers' aggregate sensitivity could depend on the prevalence of floating-rate loans and the level of household indebtedness. Based on an analysis of 8.9 million loans backing a sample of transactions that we rate, more than 90% of the pools were floating rate in Finland and Norway, compared with only 0%-10% in France, Germany, and the Netherlands, for example. However, the average level of mortgage debt in Finland is less than half that in the Netherlands, relative to disposable income.

Credit Conditions Europe Q3 2022: Pain On The Horizon

Borrowers with an adverse credit history could be more at risk, such as those backing transactions in the U.K. nonconforming RMBS sector. While they typically have a low monthly payment, averaging about £500 per month, they already exhibit high arrears levels of about 10%-20%. Most legacy loans in this sector are floating rate and interest only, making them more sensitive to a rising rate environment. Our analysis also shows that for every borrower currently in arrears, there is another borrower who is currently up to date on their payments but has been in arrears at some point in the past two years, suggesting they may also be vulnerable to future non-payment.

Forward curves imply that the recent upward trend in market interest rates is set to continue, with benchmarks reaching levels not seen in a decade by 2024. However, there a number of mitigants suggesting that consumer-backed structured finance ratings could be largely unaffected. First, in many countries, regulations require mortgage lenders to test prospective new borrowers' ability to meet their obligations at stressed interest rates well above the levels we are likely to see, even as monetary policy tightens. While inflation has proved persistent so far, we expect it to moderate through 2023, and structured finance ratings have in any case shown limited correlation with inflation over the past 20 years. By contrast, there has been a 77% correlation with changes in the unemployment rate over the same period, but we expect unemployment to remain flat.

Credit Cycle Indicator

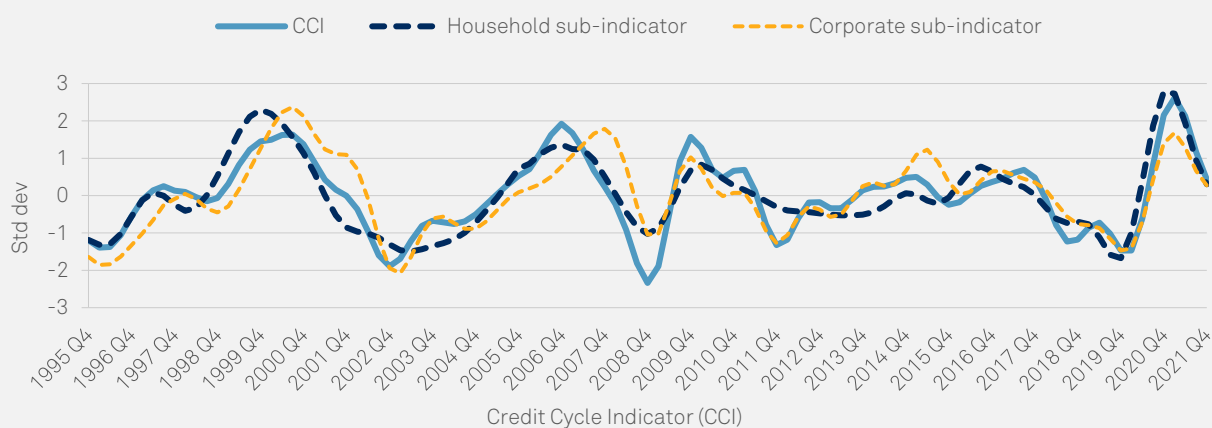
Signs Point To Heightened Credit Stress In Late 2022 Or Early 2023

We are trialing a proprietary Credit Cycle Indicator (CCI) at the macro geographical level. The CCI has five components: corporate and household debt leverage, equity and house prices, and our proprietary Financing Stress Indicator (FSI) (see "[White Paper: Introducing Our Credit Cycle Indicator](#)," published on June 27, 2022). Our preliminary results show the peaks in the CCI tend to lead credit stresses by six to 10 quarters. Moreover, when the CCI's upward trend is prolonged or the CCI nears upper thresholds, the associated credit stress tends to be greater.

Overall. Across Europe, mounting debt-to-GDP in 2020 pushed eurozone CCI figures to historic levels. Following four consecutive quarters of upward movement, the Eurozone CCI peaked in the first quarter of 2021. This suggests potential heightened credit stress in late 2022 or early 2023 (see chart 24). While the CCI is trending downward--indicating a credit correction is underway--the potential impact of the buildup of nonperforming loans (NPLs) and defaults could linger beyond the stress period across late 2022 and early 2023.

Chart 24

CCI For The Eurozone Reached A New High Early In Q1 2021, Suggesting A Risk Of Heightened Credit Stress Ahead



Note: We view the CCI as a leading indicator for potential credit stress outcomes. The CCI period ends in 2021 Q4. Household and corporate sub-indicators were created by taking the weights in the overall CCI and rescaling such that the sub-components' weights in the sub-indicator sum to 1. Source: Bank for International Settlements, Bloomberg, S&P Global Ratings.

Corporates: Since fourth-quarter 2019, the corporate subindicator has seen an upturn, which accelerated to a peak, again, in first-quarter 2021. The five-quarter upswing was driven by large-scale borrowing in the corporate sector, paired with constrained economic growth across Europe. The corporate subindex has since cooled off, falling below 1 standard deviation in third-quarter 2021, reflecting a fall in corporate debt to GDP to 132% in third-quarter 2021 (from around 139% for first-quarter 2021). Still, some fragility will remain—especially given the enormous step-up in corporate debt over the last two years, particularly for speculative-grade debt.

Households: A spike in household debt during the pandemic pushed the household subindicator to record highs of 4.1 standard deviations in first-quarter 2021, before descending rapidly toward zero. The household subindex was the key driver in the CCI's upturn. Subsequently, as household debt declined, so did the upward momentum. Historically high household savings rates have increased the stock of these savings across the eurozone, which should help shield many households from credit stress in the near term, though more indebted households may suffer as higher pricing erodes purchasing power.

Governments: Sovereign risk is not included as a formal part of the CCI, but is examined by our sovereign rating analysts.

Related Research

- [Economic Outlook Eurozone Q3 2022: Inflation Dulls The Post-COVID Bounce](#), June 27, 2022
- [Economic Outlook U.K. Q3 2022: The Great Inflation Squeeze](#), June 27, 2022
- [White Paper: Introducing Our Credit Cycle Indicator](#), June 27, 2022
- [Russia-Ukraine Military Conflict: Key Takeaways From Our Articles](#), June 24, 2022
- [Recession Risk And Ratings: What Recession Could Mean For European SG Nonfinancial Corporates](#), June 23, 2022
- [Credit Trends: From “Whatever It Takes” To Wherever It Leads: How The ECB Has Reshaped The European Economy And Markets](#), June 23, 2022
- [Rating Actions Waypoint: The Russia-Ukraine Conflict As Of June 21, 2022](#), June 23, 2022
- [Take A Hike 2022: Which Sovereigns Are Best And Worst Placed To Handle A Rise In Interest Rates](#), June 22, 2022
- [COVID-19 Impact: Key Takeaways From Our Articles](#), June 22, 2022
- [When Rates Rise: European REITs’ Funding Costs And Cap Rates Climb. So Does Revenue](#), June 16, 2022
- [European Hotel Industry Fears Inflation And Travel Reticence Could Scupper Its Strong Recovery](#), June 13, 2022
- [Rising Default Rates Signal Inflection For German, Swiss, And Austrian Corporate High-Yield Issuers](#), June 13, 2022
- [Another Turn Around The Dancefloor As European Governments Eye New Bank Windfall Taxes](#), June 9, 2022
- [European Retailers: Forced To Raise Prices While Wary Of Consumers Cutting Back Spending](#), June 9, 2022
- [European Aviation Is Set For A Strong Summer Before Brewing Macro Headwinds Blow In](#), June 8, 2022
- [When Rates Rise: Not All European Banks Are Equal](#), June 8, 2022
- [Cutting China From Supply Chains--Easy To Say, Hard To Do](#), June 1, 2022
- [The Global Food Shock Will Last Years, Not Months](#), June 1, 2022

This report does not constitute a rating action.

The views expressed in the Macroeconomic Outlook section (pages 7-9) are the independent opinions of S&P Global Ratings’ economics group, which is separate from but provides forecasts and other input to S&P Global Ratings’ analysts. S&P Global Ratings’ analysts use these views in determining and assigning credit ratings in ratings committees, which exercise analytical judgment in accordance with S&P Global Ratings’ publicly available methodologies.

Appendix 1: Economic Data and Forecast Summaries

Table 2

Real GDP %

	Ger.	Fra.	Ita.	Spa.	Neth.	Belg.	Eurozone	U.K.	Switz.
2020	-4.9	-8.0	-9.1	-10.8	-3.8	-5.7	-6.5	-9.3	-2.5
2021f	2.9	7.0	6.6	5.1	5.0	6.2	5.4	7.4	3.7
2022f	1.9	2.6	2.8	4.1	2.6	2.1	2.6	3.2	2.5
2023f	2.0	1.7	1.9	2.7	1.6	1.6	1.9	1.0	2.0
2024f	1.9	1.6	1.5	2.5	1.9	1.8	1.8	1.7	1.8
2025f	1.6	1.5	0.8	2.2	1.6	1.7	1.6	2.0	1.5

Source: S&P Global Market Intelligence; f--S&P Global Ratings forecast.

Table 3

CPI Inflation %

	Ger.	Fra.	Ita.	Spa.	Neth.	Belg.	Eurozone	U.K.	Switz.
2020	0.4	0.5	-0.1	-0.3	1.1	0.4	0.3	0.9	-0.7
2021f	3.2	2.1	1.9	3.0	2.8	3.2	2.6	2.6	0.6
2022f	7.6	5.2	6.3	7.9	8.9	8.9	7.0	8.7	2.3
2023f	4.1	2.7	2.6	3.4	4.0	3.6	3.4	4.8	1.5
2024f	2.3	2.0	1.7	2.7	2.0	2.4	2.2	1.6	1.0
2025f	2.0	2.0	1.6	2.0	1.4	1.6	1.9	1.8	0.7

Source: S&P Global Market Intelligence; f--S&P Global Ratings forecast.

Table 4

Unemployment Rate %

	Ger.	Fra.	Ita.	Spa.	Neth.	Belg.	Eurozone	U.K.	Switz.
2020	3.9	8.0	9.3	15.5	4.9	5.8	8.0	4.5	4.8
2021f	3.6	7.9	9.5	14.8	4.2	6.3	8.3	4.5	5.1
2022f	3.0	7.3	8.8	13.4	3.3	5.5	7.5	4.1	4.3
2023f	3.1	7.5	8.7	13.0	3.3	5.5	7.4	4.4	4.1
2024f	3.1	7.4	8.5	12.9	3.3	5.4	7.3	4.1	3.9
2025f	3.0	7.4	8.4	12.7	3.3	5.4	7.2	4.0	4.0

Source: S&P Global Market Intelligence; f--S&P Global Ratings forecast, annual averages.

Table 5

10y Government Bond Yields

	Ger.	Fra.	Ita.	Spa.	Neth.	Belg.	Eurozone	U.K.	Switz.
2020	-0.5	-0.2	1.2	0.4	-0.3	-0.1	0.1	0.3	-0.5
2021f	-0.3	-0.1	0.8	0.4	-0.2	0.0	0.0	0.7	-0.3
2022f	1.1	1.5	2.9	2.1	1.2	1.6	1.6	1.9	0.9
2023f	1.7	2.1	3.6	2.8	1.7	2.3	2.2	2.6	1.2
2024f	1.8	2.3	3.8	3.0	1.9	2.5	2.3	2.7	1.3
2025f	2.1	2.6	4.2	3.4	2.2	2.9	2.7	2.8	1.5

Source: S&P Global Market Intelligence; f--S&P Global Ratings forecast, annual averages.

Table 6

Exchange Rates

	Eurozone		----- U.K.-----		Switzerland	
	US\$/€	US\$/£	€/£	SFr/US\$	SFr/€	
2020	1.14	1.28	1.12	0.94	1.07	
2021f	1.18	1.38	1.17	0.91	1.08	
2022f	1.09	1.29	1.19	0.94	1.02	
2023f	1.12	1.29	1.15	0.92	1.03	
2024f	1.16	1.40	1.21	0.91	1.06	
2025f	1.17	1.44	1.23	0.91	1.06	

Source: S&P Global Market Intelligence; f--S&P Global Ratings forecast, annual averages.

Table 7

Policy Interest Rates %

Policy Rates	----Eurozone (ECB)----		U.K. (BoE)	Switzerland (SNB)
	Deposit Rate	Refi Rate		
2020	-0.50	0.00	0.16	-0.75
2021f	-0.50	0.00	0.12	-0.75
2022f	-0.19	0.83	1.31	-0.48
2023f	0.96	0.83	2.00	0.56
2024f	1.50	1.75	2.06	0.75
2025f	1.50	2.00	2.25	0.75

Source: S&P Global Market Intelligence; f--S&P Global Ratings forecast, annual averages.

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