

Credit Conditions Europe: Reining In As Full Recovery Nears

Key Takeaways

- **Overall:** Strong demand and falling unemployment create a fundamentally positive outlook for credit in 2022, although cost pressures, monetary policy tightening, and Europe's fourth COVID-19 wave, now compounded by omicron, are headwinds to monitor.
- **Risks:** Broadening cost pressures accelerating the pace of tightening and vulnerability from the further accumulation of debt are our two top European risks. We see elevated risks around building and maintaining immunity to COVID; accelerating the transition to a low-carbon economy; and protecting vital digital infrastructure from cyber attacks.
- **Credit:** Financing conditions and credit trends remain supportive, tempered by growing shareholder-friendly activity and a still high proportion of 'B-/CCC' corporate ratings.

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Credit prospects are broadly favorable as the region fully recovers lost output, growth remains above trend, vaccines remain effective against the delta variant, and financing conditions remain benign despite a gradual rise in benchmark yields. Rising inflation pressures and central bank responses, pandemic fatigue amid new variants and vaccine hesitancy, and potential negative spillovers from slowing growth in China are key headwinds to monitor.

Solid demand-led recoveries in most sectors with ends to restrictions are enabling businesses to pass through sharply higher input costs and adapt to supply shortages so far, with a limited hit to financial performance. While this remains the case, we expect credit quality broadly speaking to continue transitioning positively, even though the recovery in some more COVID-19-sensitive service sectors is lagging – such as travel, hospitality, and leisure. Nonetheless, with almost 60% of our corporate analysts expecting cost pressures to persist until year end, the possibility remains that margins may falter if demand slows faster than we expect, wage pressures rise, and businesses lose pricing power.

The landscape for European banks appears stable as the operating environment poses far less threat to balance sheets than a year ago. While problem assets remain likely to rise, we expect provisioning needs will be contained. Capital ratios could decline as shareholder distributions rebound, and large banks will be less constrained by now diluted and delayed Basel III reforms until January 2025. Transforming business models remains key to increase profitability to at least match costs of capital while adapting to transformative digitalization trends and competition from fintech entrants. Investment, cost-cutting, exiting noncore businesses, domestic consolidation, and fee income generation are all areas in focus. Even so, we expect average RoE for the top 100 European banks to rise to only 5.9% from 5.4% in 2021.

This improving economic outlook is increasingly positive for credit performance in structured finance. Transactions backed by consumer assets look set to see minimal deterioration as the wind-down of borrower support schemes appears well-synchronized with counteracting improvements in labor markets. The declining default rate also indicates fewer risks in the CLO sector, although areas of commercial real estate--and therefore CMBS--remain under pressure.

European insurers are well prepared for forthcoming challenges now that capital surpluses have returned to pre-pandemic levels. Despite some pick-up of competition in motor insurance, non-life insurance is likely to maintain solid insurance margins. While low and negative interest rates remain a burden for life insurers, we observed a bottoming out of margins. Progressive dividends, share buybacks, and M&A have reemerged as the main factors limiting potential ratings upside.

Local and regional governments face a particular confluence of challenges next year. Near term, the phasing out of government grants, subdued tax growth, and inflation will make it harder for them to adapt to longer-term issues coming back into focus--principally demographic pressures and decarbonization. This could lead to higher LRG credit volatility over the medium term.

Top European Risks



Risk levels are based on 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 on whether the risk level could increase or decrease over the next 12 months.

Supply chain constraints and broadening cost pressures prove longer lasting

High demand, rising energy prices, and supply bottlenecks are driving input costs and inflation higher, highlighting vulnerabilities in global supply chains. With the majority of corporate sectors being able to pass these higher costs through to end-customers and expecting little respite until second-half 2022, the risk is that a rise in inflationary expectations and wage pressures would require the ECB to bring forward the start of their rate tightening cycle. The return of rates in the EU to positive territory is likely to create some financial market turbulence and tighten financing conditions. While inflation pressures are a greater near-term concern in the U.S. at this point in the cycle, Europe faces a similar predicament and is exposed to potential financial spillovers from the U.S.



Accumulated corporate and government debt creates fragility on the path to policy normalization

Economic recovery and ongoing extraordinary monetary and fiscal stimulus could create complacency about the enormous step-up in corporate and sovereign debt over the last 18 months. Though debt-servicing costs remain historically low, fragilities may become more pronounced in the coming years, especially for corporates, given the still high 30% of speculative-grade companies (rated 'B-' and lower) that we view as vulnerable. The structural task of strengthening balance sheets also extends to governments and central banks. This will be a multiyear process with the prospect that political considerations could impede and delay the necessary budgetary consolidation we expect to commence in 2022. This is required to maintain sovereign credit quality and restore the fiscal headroom necessary to fight the next financial shock.



Vaccine-resistant coronavirus strains slow the economic recovery

High vaccination levels have underpinned rising consumer and business confidence, with mobility and footfall in the retail and domestic leisure sectors back close to pre-pandemic levels. But delta infections are rising and back above peaks in some Northern European countries, even though hospitalizations remain well below previous highs. While this could still cause some disruptions over the winter if high community transmission levels require some incremental restrictions (particularly for the unvaccinated), greater downside economic risks could arise from a rapid decline in vaccines' efficacy, growing mistrust of vaccines as boosters are rolled out, or, importantly, if omicron proves to be an escape variant that overwhelms health care systems once again.



Structural Risks

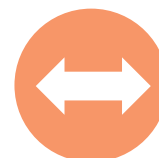
Transition toward a net-zero economy presents challenges and risks as ambition ratchets upward

Mounting concern about the impacts of severe man-made climate change has raised the bar for governments' commitment to protect the environment. The EU's Fit for 55 program, targeting a 55% cut in carbon emissions by 2030, remains the most ambitious regional plan, even after many countries raised their targets at COP26. This ambitious target will disrupt industries and business models, creating winners and losers. The hardest hit are likely in the automotive, building, cement, steel, transportation, and utilities sectors. More broadly, the move away from fossil fuel to renewables for electricity generation calls on companies to plan now to secure future power needs. Plus, global policy alignment, including regulation, is needed to reach the net-zero target but will inevitably create tensions among governments, as seen in the COP 26 pledge to only "phase down" instead of phase out the use of (unabated) coal in certain countries.



Critical global infrastructure and interdependent digital networks are highly vulnerable to cyber attacks

The next major threat to the global financial system could easily be cyber related, given greater correlated risk and more rapid contagion than suggested by historical experience. This is due to opaque and complex global supply chains as well as a digitally interconnected ecosystem, often with reliance on a concentrated number of cloud service providers. Such an event could trigger widespread rating actions, particularly for entities with weaker balance sheets that lack adequate cyber insurance or other means of liquidity to address the potential financial impact.



This report is an extract from “[Global Credit Outlook 2022: Aftershocks, Future Shocks, And Transitions](#)”, Dec. 1, 2021.

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