Global Banks: Our Credit Loss Forecasts

Manageable rise in credit losses as our base case

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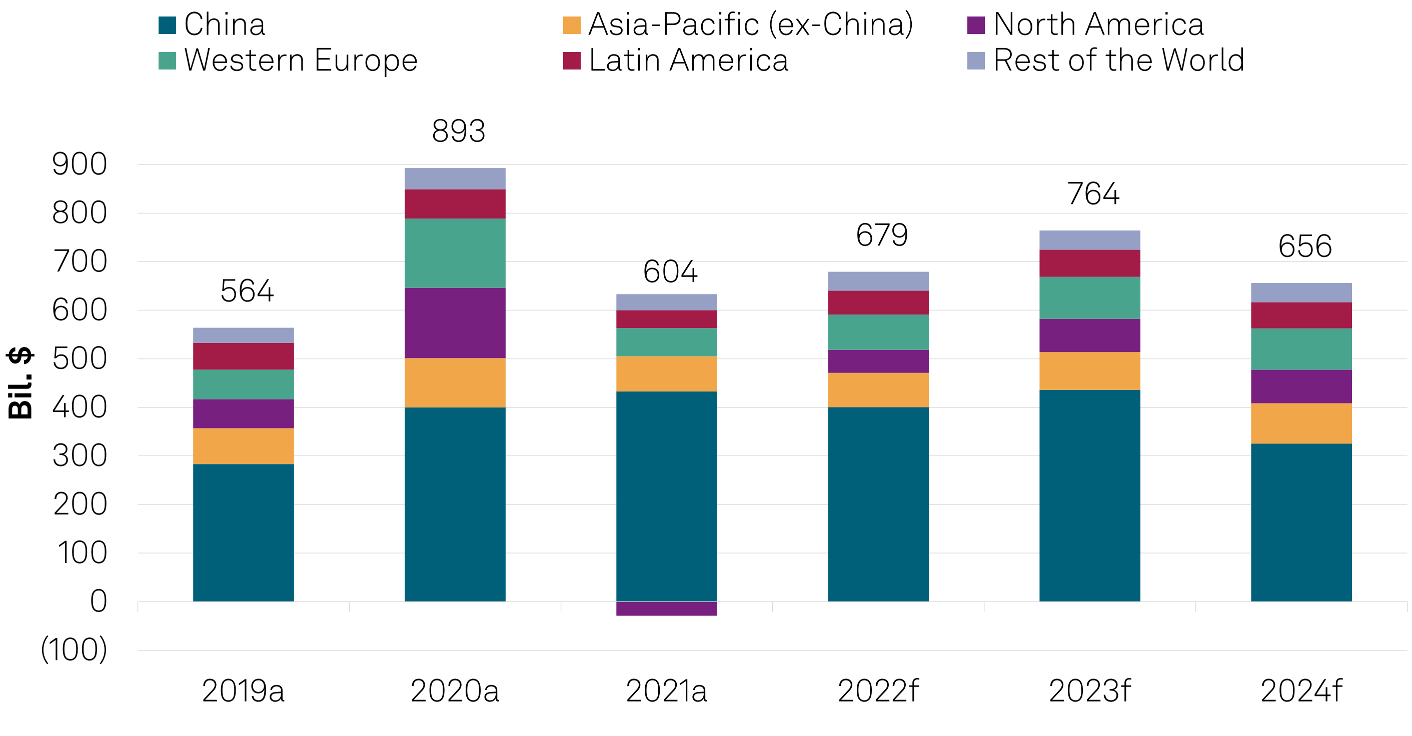
Global Bank Credit Losses: Our Base Case Sees Higher, But Manageable, Losses Ahead

Domestic credit losses by region, 2019-2024



Data for China relates to commercial banks. a—Actual. f—Forecast. Source: S&P Global Ratings.

- Across the 83 banking systems that S&P Global Ratings covers, we expect credit losses will amount to around $2.1 trillion over the three years to end-2024.
- China's commercial banking system accounts for just more than one-half of this total, reflecting its sheer size in a global context. In terms of customer loans, the Chinese banking system is approximately the same size as the U.S., Japanese, German, and U.K. banking systems combined.
- A silver lining: Global banks enter 2023 with broadly healthy capital and solid balance sheets, and their net interest margins will continue to benefit from higher interest rates. This should provide comfortable headroom to absorb higher losses without depleting capital.

Our Base Case Economic Forecasts Underpin Our View About Credit Losses

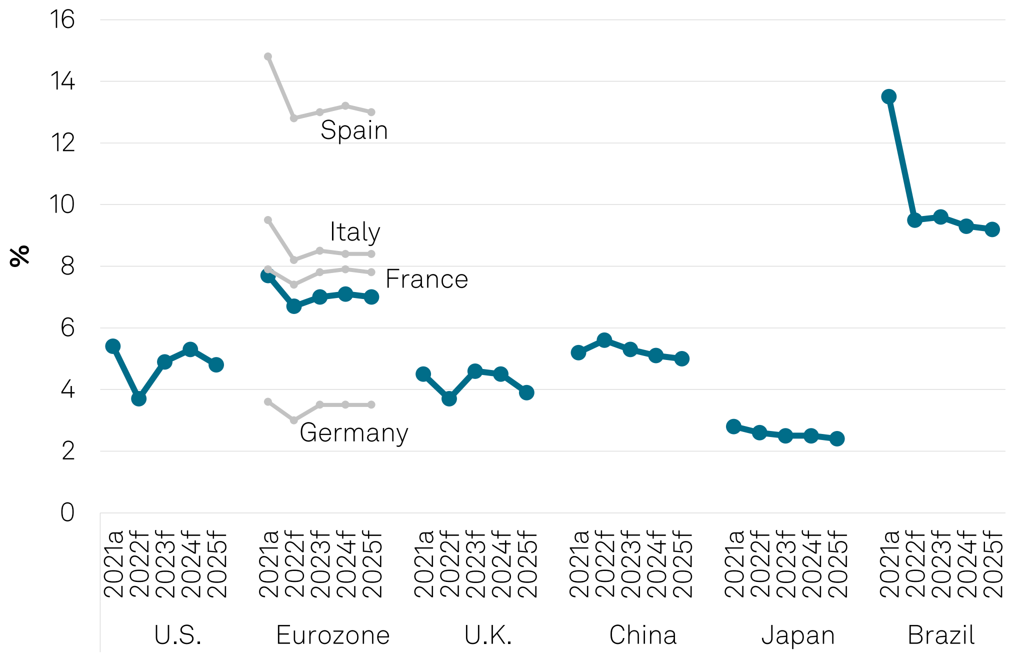
Our estimates for banks' credit losses are grounded in our base case economic forecasts, which see a sharp GDP slowdown in 2023, while unemployment--historically a key driver for bank credit losses--remains contained

GDP: A Tough Year Ahead, Gradual Recovery Thereafter

	2022	2023	2024	2025
U.S.	1.8	(0.1)	1.4	1.8
Eurozone	3.3	(0.0)	1.4	1.5
Germany	1.8	(0.5)	1.0	1.3
France	2.5	0.2	1.6	1.5
Italy	3.8	(0.1)	1.4	1.2
Spain	4.6	0.9	1.9	2.5
U.K.	4.3	(1.0)	1.3	1.5
China	3.2	4.8	4.7	4.8
Japan	1.5	1.2	1.1	1.1
India*	7.0	6.0	6.9	6.9
Mexico	2.6	0.8	2.0	2.3
Brazil	2.9	0.5	2.0	2.2
South Africa	1.9	1.5	1.7	1.7
World	3.4	2.2	3.1	3.3

GDP growth, annual percentage change. *Fiscal year, beginning Apr. 1 in the reference calendar year. Source: S&P Global Ratings.

Unemployment: Remaining At Multiyear Lows



A--Actual. F--Forecast. Source: S&P Global Ratings.

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The Downside Risks To Our Forecast Remain Significant

Harsher economic and financing conditions than envisaged in our base case represent a significant downside risk to our forecasts for credit losses.

In particular, weaker economic performances could result in higher corporate insolvencies, where leverage is extremely high, fueling higher credit losses.

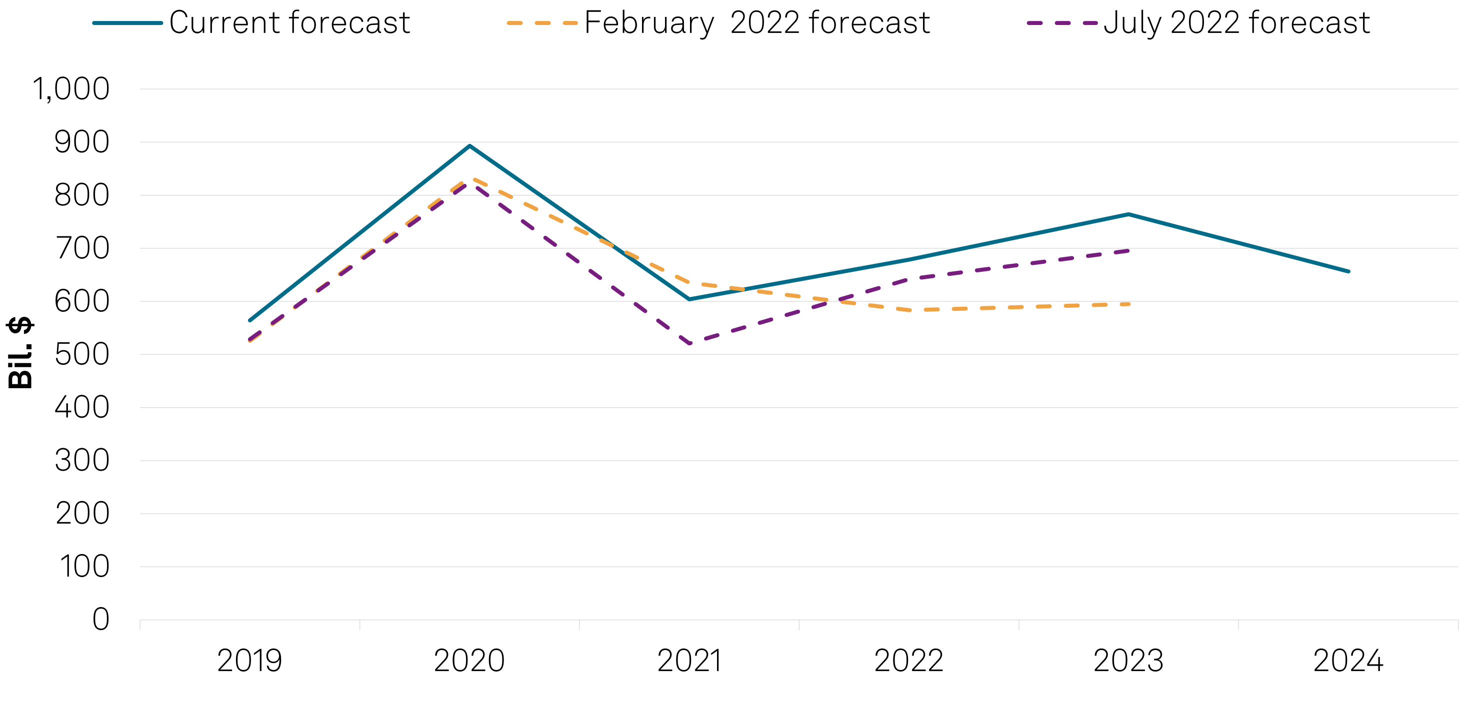
The high levels of indebtedness of many sovereigns diminish their capacity to provide support to their economies, exposing banks more directly to borrowers facing repayment stresses.

Although higher interest rates will boost banks' net interest margins, should rates rise higher or faster than we expect--for example, to address persistent inflation concerns--the resulting pressures on household and corporate borrowers would likely push more of them toward default.

Falling residential and commercial property prices across much of the world could further undermine household or corporate confidence.

Our 2022 And 2023 Forecasts Are Higher Than In Previous Years

Evolution Of Credit Loss Forecasts, 2019-2024

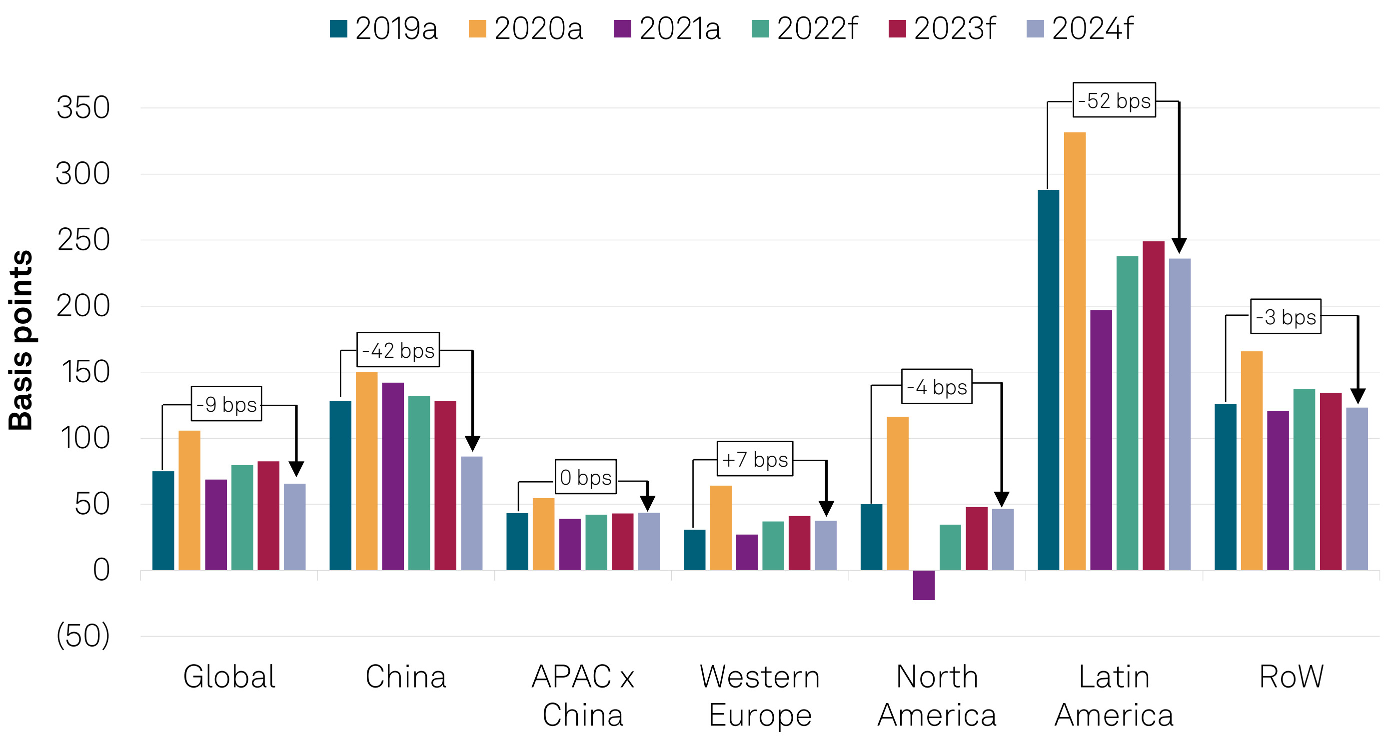


Note: The chart's solid line shows our current credit loss estimates or forecasts for 2019-2024; in that line, data for 2019-2021 is actual. Source: S&P Global Ratings.

- While our forecast for 2024 is new, our latest forecasts for 2022 and 2023 are appreciably higher than our previous (July 2022) projections.
- For 2022, we see credit losses amounting to around $680 billion, 6% above our previous forecast of around $640 billion.
- For 2023, our forecast is around $765 billion, 10% higher than our previous forecast of around $695 billion.
- This deteriorating picture--and many of the regional variations we discuss in this report--highlights the increasingly murky economic outlook across much of the world.

Credit Cost Ratios Will Return To 2019 Levels By 2024

Evolution Of Credit Cost Ratios By Region, 2019-2024



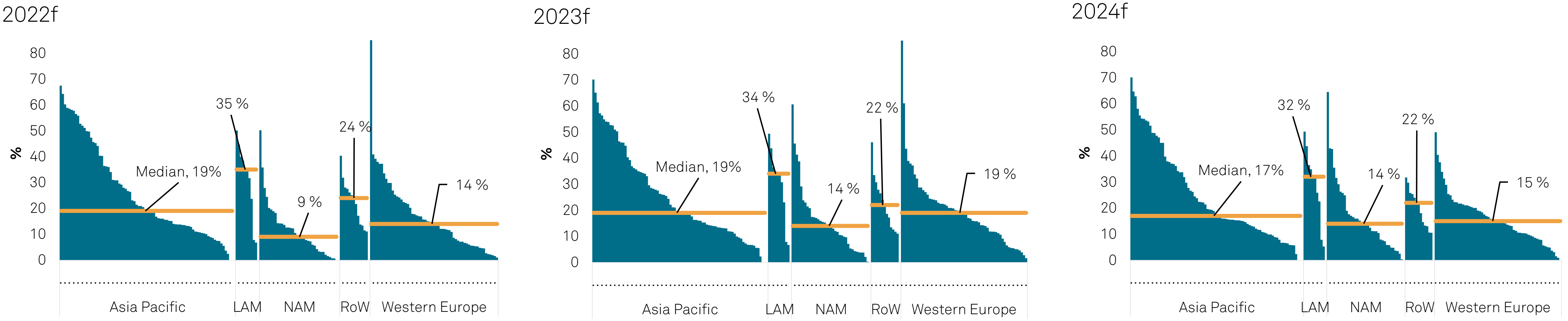
Note: The figures in boxes indicate the change in credit cost ratios in 2024f compared with 2019a. Data for China relates to commercial banks. a--Actual. f--Forecast. APAC--Asia-Pacific. RoW--Rest of the world. bps—Basis points. Source: S&P Global Ratings.

- We estimate banks' credit cost ratios--credit losses as a proportion of customer loans—will average about 80 basis points (bps) in 2022 and in 2023.
- The ratio will then likely fall back to around 65 bps in 2024, comparable with the 2019 (pre-pandemic) level of around 75 bps.
- This compares to about 100-120 bps in the aftermath of the 2008-2009 global financial crisis. (Note: this comparison is not like for like due to factors such as enhanced accounting rules for credit losses and changes in the composition of global bank lending.)

Most Major Banks Will Be Able To Absorb Credit Losses From Earnings

- We estimate that the top 200 rated banks represent about two-thirds of global bank lending. For these banks, we estimate that credit losses will absorb about 25% of their 2022 pre-provision earnings on average--the same level as the 2019 average.
- Regionally, over the three years to end-2024, we estimate that median credit losses will range from about 9%-19% of earnings in North America and Western Europe to around 35% of earnings in Latin America.
- These figures illustrate relatively healthy capacity across the top 200 banks in aggregate to absorb further losses without depleting capital.

Forecast Credit Losses To Pre-Provision Earnings For The Top 200 Rated Banks, 2022-2024, By Region



f--forecast. LAM--Latin America. NAM—North America. RoW--Rest of the world. For 2022f, negative values of 6.6% and 5.7% for two banks are not shown, and one bank has a ratio of 107%. For 2023f, a negative value of 1.4% for one bank is not shown, and one bank has a ratio of 134%. Source: S&P Global Ratings.

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What's On The Horizon For Bank Credit Losses?

An overview of credit loss forecasts by region

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China

- For China, we forecast that credit losses will average around 2.2 trillion renminbi a year from 2022-2024.
- We estimate that about 40% of Chinese property developers are in financial difficulty, and we expect real estate NPLs (nonperforming loans) to remain elevated in 2023, after doubling in 2022. They would be higher still if not for forbearance policies allowing banks to classify credit stress among developers as normal or special-mention loans. Reasonable collateral buffers on real estate loans support this approach, and we still expect banks will reclassify the loans to NPL if their loan-to-value ratios approach or exceed 100% on already problematic loans.
- We forecast that national home prices will decline by up to 8% in 2023. The chance of a hard landing for banks is remote at this stage, though pockets of regional sensitivities could chip the banking sector's health at the fringes. Credit losses from mortgage loans are currently minimal, and pressures from the mortgage boycott incident are subsiding with policy efforts to hasten stalled home completion.
- Asset quality pressures continue to build for micro and small enterprise (MSE) loan portfolios. This is due to business concentration, a sluggish recovery in consumption, and margin squeezes. It is unclear the extent to which MSE borrowers invested loan proceeds to sustain long-term margins, which would support repayment. The policy push to increase the proportion of unsecured loans to MSEs could see elevated write-offs later on.
- We believe credit costs should begin to stabilize. Big and better-resourced banks that have been preparing for a rainy day can cautiously relax their provision coverage. However, weak banks will continue to feel the pinch to provide more.

Asia-Pacific (Excluding China)

- Our economic growth forecast of 4.3% for the Asia-Pacific region for 2023 is stronger than for the U.S. (-0.1%) and the eurozone (0.0%). This will underpin bank lending growth and result in manageable credit losses for most banks at current rating levels. For 2023, we forecast credit losses of about $77 billion for the Asia-Pacific region, excluding China. This is about 7% higher than in 2022.
- Certain risks could push credit losses higher than our base case forecasts. While positive, growth will remain below-trend in numerous jurisdictions. Meanwhile, inflation, interest rates, and borrowing costs will remain elevated, according to our base case. Materially lower growth and higher interest rates than we expect will result in a tougher test for asset quality and materially higher credit losses than envisaged by our base case, which will erode bank buffers and contribute to negative ratings momentum.
- Latent risks to asset quality include a weaker corporate sector outlook, high loans under moratorium in jurisdictions in south and southeast Asia, potential spillover on banks from stress on the commercial property development sector in China, as well as high household debt in the context of higher interest rates in Australia, New Zealand, and Korea. Furthermore, asset quality weakness may be felt more acutely by nonbank financial institutions than banks.
- Leading into 2023, many financial institutions show sound asset quality and provisioning and stable capitalization. Furthermore, employment trends remain strong in many jurisdictions, and household savings remain elevated in the wake of the pandemic. These factors will assist in buffering asset quality pressures.

North America

- We forecast credit losses of about $138 billion for the two years to end-2024 for North America, driven by loan growth and a likely deterioration in asset quality as the economy weakens. At just under $70 billion per year, we expect credit losses to top the pre-pandemic level of about $60 billion in 2019 and what will likely be less than $50 billion in 2022.
- That said, the increase would represent more of a return to historical norms than necessarily a surge. Our forecasted credit losses would equate to just under 50 bps, about where they were in 2019 and often before then. We expect the U.S. to enter a mild recession in 2023 and Canada to register no growth for the full year, before some rebound in both countries in 2024. With that backdrop, banks will very likely increase their allowances for credit losses in advance of a rise in charge-offs.
- We view the rise in credit losses as manageable for banks in North America but believe the risks are on the downside. In our economists' downside scenario, inflation remains high, pushing the Fed to continue to raise rates aggressively, and savings and consumer spending decline while unemployment rises significantly. In that scenario, we would expect credit losses as a share of loans to exceed historical norms and further eat into earnings.

Western Europe

- We expect Western European banking systems will record credit losses of around $72 billion in 2022, or 25% above the losses experienced in 2021. Because the 2021 figure ($58 billion) reflected substantial levels of write-backs of pandemic-related credit loss provisioning, this implies no real pickup for 2022.
- For 2023, we expect credit losses to rise by around 20% to $87 billion, and remain around this level in 2024.
- These forecasts reflect our view that the ongoing energy shock and monetary tightening will see problem loans emerge across Europe's banking systems, most likely among corporate borrowers with more stretched debt and affordability metrics or more directly affected by higher costs--particularly if they have limited ability to pass them on to consumers through prices.
- At the same time, we expect that a modest rise in unemployment across Europe (our base case expectation) means that the quality of household exposures, particularly mortgages, should remain resilient.
- We expect the higher losses we forecast to be manageable for banks, largely thanks to rising interest rates benefitting net interest margins.
- Still, there is not much room for optimism. Upside risks are few, and downside risks abound. For example, inflation may be more persistent than we expect, which would result in a stronger and longer policy response, or the Ukraine conflict could further exacerbate the ongoing energy crisis. This would take a greater toll on banks' asset quality, raising credit losses.

Latin America

- We forecast credit losses of $110 billion for the two years to the end of 2024 for banking systems in Latin America, with the bulk of these in the region's largest economies, Brazil ($56 billion) and Mexico ($17 billion).
- A likely weaker economic performance in 2023 and lower credit growth should push up credit losses. However, we expect them to remain manageable thanks to banks' conservative growth strategies before and during the pandemic and to high margins and provisioning coverage, which have generally remained higher than global peers.
- We expect consumer loans and micro, small and midsize enterprise loans to drive asset quality deterioration.
- Lending growth should moderate in 2023 due to weaker credit demand from the corporate sector and a reduction in banks' risk appetites as economic conditions weaken.
- Soft economic performances and political uncertainty, which limit investment and internal demand, will slow credit growth in 2022. We expect the retail sector to be the main driver of credit growth.

Central And Eastern Europe

- We expect the banking sectors of Azerbaijan, Armenia, Georgia, Kazakhstan, and Uzbekistan will continue recovering as their economies regain strength.
- Our forecast for GDP growth--on average close to 4% for 2023, after about 6% in 2022--will continue to support new loan generation and improve credit quality for these jurisdictions. We expect credit costs will continue normalizing toward 1.3%-1.5% on average, from 1.5%-2.0% in 2021.
- Despite previously close links with Russia, these economies have not significantly suffered from Russia's steep economic decline since the onset of the war with Ukraine. In fact, they have benefited this year thanks to inflows of nonresident deposits, growth of non-interest revenues, and inflows of qualified migrants. This impact will likely continue into 2023, albeit to a lesser extent.
- Ukraine's economy and banking system face unprecedented disruption from the Russia-Ukraine conflict. We expect negative NPL trends and credit losses to continue in 2023. The challenging macroeconomic environment means that the banking sector will suffer further, squeezing banks' earnings, asset quality, as well as funding and liquidity.
- Belarus is facing mounting economic, balance-of-payments, and financial stability risks, because of international sanctions on Belarus and Russia, its key trading partner.

Middle East And Africa

- In Gulf Cooperation Council (GCC) countries, thanks to the supportive macroeconomic backdrop, we expect only a marginal buildup of new NPLs. We don’t expect the NPL ratio will exceed 5% for the top 45 banks in the region, versus about 3.5% as of June 30, 2022. We also expect their profitability to recover to pre-pandemic levels, helped by higher interest rates, strong efficiency, and lower cost of risk.
- In Turkiye, surging real estate prices and a highly accommodative monetary policy are fueling imbalances. We expect banks' credit losses will average 320 bps a year in 2022 and 2023, and NPLs to increase to 4%-5%. NPL ratios have been contained by a strong real estate market, credit expansion at deeply negative real interest rates, and large restructured loans that haven't been recognized as delinquent. A sharp drop in house prices could boost credit losses for the banking system.
- For South African banks, we expect credit losses to average 1% of total loans through 2023, from a high of 2.1% in 2020. Top-tier banks should outperform lower-tier banks because the latter have larger unsecured lending exposures. NPLs should gradually decline to about 4% of systemwide loans by 2023. We believe that credit conditions will remain tight through 2023 and anticipate that credit growth will remain muted over the next three years, averaging 5%.

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