NUS National University of Singapore | RMI Advancing Risk Management for Singapore and Beyond

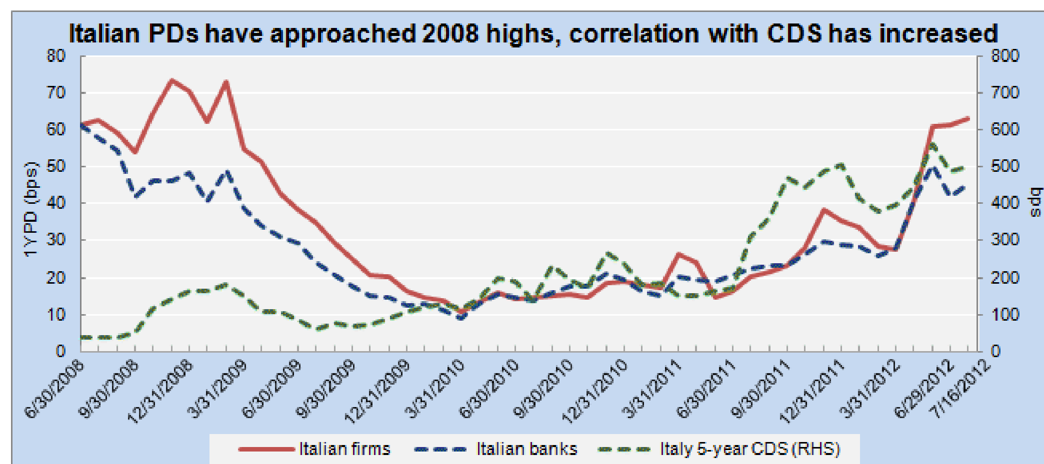
Weekly Credit Brief

Jul 10 - Jul 16 2012

Story of the Week

Italian RMI PDs approach GFC highs before Moody's downgrades government, banks

The 1-year aggregate PDs for Italian firms and banks have jumped dramatically since March, approaching highs not seen since the height of the Global Financial Crisis in late-2008. The upward trend in each aggregate started over a month before Moody's downgraded the Italian sovereign rating on July 13, and a number of Italian banks and firms on July 16. The outlook for Italian firms is likely to remain poor, as a struggling economy weighs on earnings prospects, while market conditions continue to leave Italian firms exposed to funding pressures. These factors also weigh upon the earning and funding profiles of Italian banks, while increasing linkages between the Italian sovereign and banks also negatively affect the credit outlook of Italian lenders.



Potential deep recession: The Italian economy entered a technical recession in Q1, contracting 0.8% after shrinking 0.7% in Q4 2011. The economic decline is likely to continue through 2012, as consumer confidence is at all time lows, while retail sales fell 6.8% year-on-year in April, the fastest rate historically. Markit/ADACI PMI indices continued to indicate a sharp contraction in the manufacturing and service sectors in June. The unemployment rate remained above 10% during Q2, and hit a new 12-year high of 10.2% in April. In addition, the government approved EUR 4.5bn in spending cuts for the fiscal year ending June 2013 on July 5 which could, together with ongoing austerity measures, lead to a further contraction in demand.

Ongoing high market rates: A weakening economy raises concerns that the government deficit will overshoot fiscal targets, which may place upwards pressure on the government's cost of funding. Yields on Italian bonds closed above 6.1% on June 17. Moreover, market yields are likely to continue to reflect concern that Italy may be the next country to require a bailout, given immense government funding needs of EUR 415bn during this fiscal year. Stubbornly high yields on sovereign bonds weigh upon the funding profiles of domestic companies, and increase the risk that the government will be unable to support Italian firms.

Increasing linkage between state and banks: The correlation between CDS contracts on Italian sovereign debt and the RMI aggregate PD for Italian banks has increased in the last three months. A similar relationship between Spanish sovereign CDS contracts and Spanish banks was evident in the weeks before Spain sought EUR 100bn from the EU to rescue its struggling banks. The EUR 3.9bn state bailout of Italy's third largest lender Banca Monte dei Paschi di Siena in June illustrated the risk of this relationship. The bank reportedly held EUR 25bn in Italian sovereign debt at the end of Q2, or 10% of the bank's total assets. Falling prices on these holdings during Q2 rapidly consumed the bank's capital.

Weak bank earnings performance: Lenders are expected to struggle if the recession deepens; demand for loans has fallen 0.7% since the beginning of 2012. Although a majority of Italian banks remained profitable during Q1, banks benefitted from non-reoccurring gains, arising from accounting technicalities and profits from carry trades financed by cheap 3-year LTRO ECB loans. High exposure to a shrinking domestic economy will likely constrain future earnings, which is also illustrated by a 15.1% year-on-year increase in bad debt at Italian lenders

during May, to EUR 110.8bn.

Sources:
Italian government downgraded to Baa2 from A3, negative outlook maintained (Moody's)
Moody's cuts ratings of Italian banks, companies (Reuters)
Italy approves EUR 4.5bn in spending cuts for 2012 (WSJ)
Monte dei Paschi targets return to profit (FT)

In the News

JPMorgan's whale loss swells to USD 5.8bn
Jul 13. JPMorgan restated Q1 earnings, revising losses attributed to the London-based CIO unit to USD 5.8bn, almost triple the USD 2bn figure announced in May. The bank admitted that there was a material weakness in its internal controls, as concerns that CIO traders had masked losses by marking CDS positions favorably was the main reason for the restatement. CEO Jamie Dimon said the bank had significantly reduced the positions, but warned JPMorgan could incur further loss of USD 800mn to 1.7bn. In positive news, the bank beat analyst's earnings expectations in Q2, reporting net income of USD 5bn. JPMorgan reported net income of USD 5.4bn for Q2 2011. (Channel News Asia, FT)

Fitch affirms US AAA credit rating, outlook still negative
Jul 10. Fitch Ratings said the US government's inability to reach a decision on deficit reduction measures weighed upon an otherwise diversified and wealthy economy. The CRA affirmed the US sovereign credit rating at AAA, with a negative outlook. Fitch also said that a possible recession in Europe and increasingly ineffective monetary policy also negativly affect the US credit outlook. The announcement came almost a year after competitor S&P downgraded the US sovereign rating to AA+. Moody's maintains an Aaa rating on the US government; all three CRAs currently hold a negative outlook for the nation, with the next US rating reviews by each CRA not expected until at least 2013, after the upcoming presidential election. (Reuters)

Standard credit ratings can boost cross-border Asian borrowings
Jul 16. A standardized Asian credit rating system would boost cross-border borrowings, and help finance projects in a region where infrastructure demand is growing rapidly. Currently, domestic CRAs in Asia rate bonds with reference to their respective sovereign, making regional comparisons difficult. Officials from Rating Agency Malaysia Berhad said efforts to establish a common credit rating system have been ongoing for the last 10 years, with domestic Asian ratings agencies playing a leading role. However, the effort has been delayed by bond markets that are at differing stages of development, and the diverging business drivers of domestic Asian CRAs. (The Malaysian Reserve)

China's corporate bond market booms
Jul 12. Despite a slowing economy, the Chinese bond market continues to expand. New bond issuance soared in the first half of 2012, up 60% from the same period in 2011. Equity and bank lending have remained sluggish this year, indicating that Chinese markets are gradually transitioning to more direct forms of financing. Government officials have previously warned that corporate overreliance on bank credit and off balance-sheet lending was a danger to the economy. Deregulation and streamlining of bond registrations has played a large role in the increase in new issuance, while an increase in exchange-traded bonds contributed to the increased liquidity in Chinese bond markets. (FT)

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