More resilient outlook for banks amid Covid-19 crisis compared to 2008 financial crisis

by Anna Sophie Wupper

The last financial crisis and this Covid-19 crisis do not have the same origin – while the former started as a banking crisis, triggered by bad banking practices, the latter is a crisis of the real economy which is caused by a pandemic and has detrimental impacts on banking and capital markets as well. However, both affect the global economy as well as financial markets. Therefore, the current situation is often compared with the financial crisis, whereby many voices say that banks are better prepared now. In this Covid-19 crisis, the bank's credit risk worldwide rose to its highest level since 2012. But compared to the 2008 financial crisis, the risk forecast offers the soothing outlook that in the future no comparable dimensions will arise in terms of default probabilities.

Figure 1a presents the NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) of all publicly listed banks worldwide as well as of the top 5% of CRI Systemically Important Banks (CriSIBs), i.e., the 56 systemically most important banks as of Mar 2020. In general, globally listed banks showed a very stable Agg PD prior to the second half of Feb 2020 but their Agg PD increased afterwards up to 20.79bps at the end of Mar 2020. This level reflects the highest risk since 2012 amid the recovery of the 2008 crisis. Followed by a short oscillation, the current Agg PD amounts to 16.43bps. Banks within the top 5% of CriSIBs also showed a similar trend with higher increase after Mar 2020 at an overall higher PD level. Keeping track of CriSIBs is particularly important during crises since the failure can lead to a cascade effect, as experienced with the collapse of Lehman Brothers. Figure 1b presents the Agg PD of all banks as well as of today's top 5% of CriSIBs during the 2008 financial crisis. A comparison between both figures shows that for now, the Agg PD of this Covid-19 crisis is not as high as in the last financial crisis.

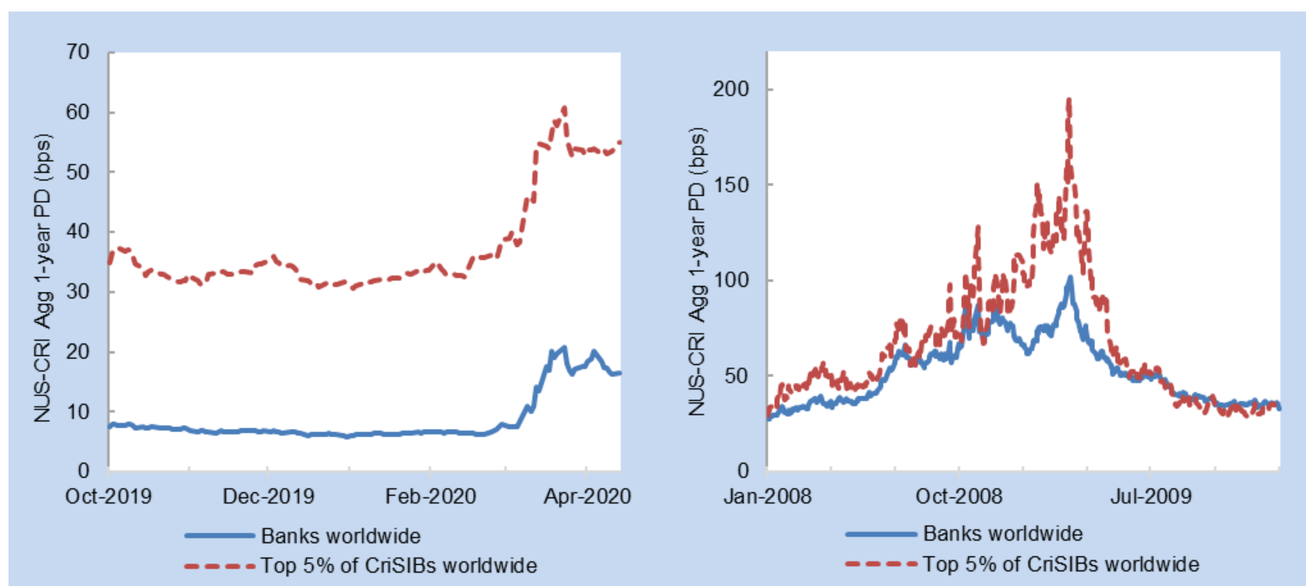

Figure 1a (LHS): NUS-CRI Agg 1-year PD of banks worldwide and of top 5% of CriSIBs worldwide; Figure 1b (RHS): NUS-CRI Agg 1-year PD of banks worldwide and top 5% of CriSIBs worldwide. *Source: NUS-CRI.*

Figure 2 presents the PD distribution in Apr 2020 and Mar 2009 according to the Probability of Default implied Rating (PDiR)[1]. The comparison shows a more favourable distribution of banks in 2020 regarding their Agg PD. Around the PD peak of the 2008 financial crisis in Apr 2009, only 21.19% of all banks today would have been considered as investment grade, whereby today more than three times as much (66.64%) make up for the proportion of investment grade-rated banks.

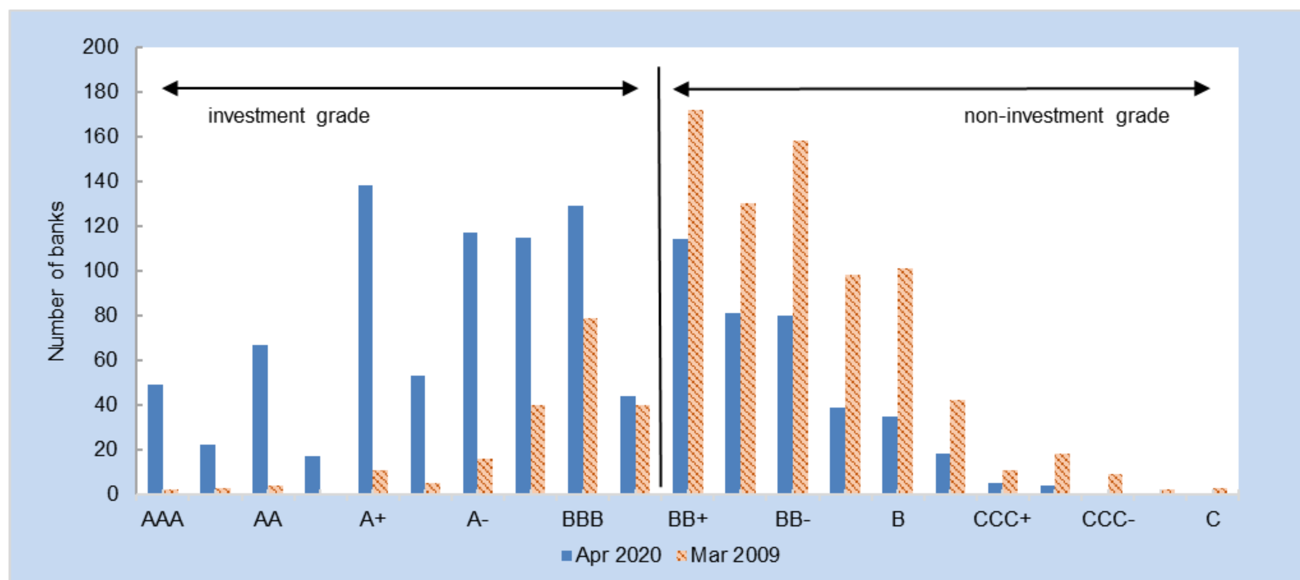

Figure 2: Distribution of Agg PDs of Mar 2009 and Apr 2020, respectively, according to PDiR using 10 day moving average. *Source: NUS-CRI.*

Several risk-limiting measures are the reason that the inevitable increased credit risk in this crisis can be partly offset. After the 2008 financial crisis, banks are obliged to meet strict requirements regarding risk management, liquidity, refinancing possibilities and capital strength. For the latter, the world's 106 biggest international banks have increased their Common Equity Tier 1 capital (CET1) from USD 2.11tn in 2011 to USD 4.03tn. CET1 is the highest quality of regulatory capital in order to provide a strong loss absorption immediately at occurrence. Furthermore, Basel III, an internationally agreed framework on capital adequacy, stress testing and market liquidity risk, was released to respond to deficiencies in financial regulation by increasing bank liquidity and decreasing bank leverage. Within the European Union, the Capital Requirements Regulation and the Capital Requirements Directive were released, which rules are mandatory for banks. In general, banks are expected to tie up capital if possible, i.e., no increase of capital distributions as well as conserving capital by freezing dividends and reining bonuses. Although halting dividends affected investor sentiment negatively in the short run and share prices of several banks dropped, in the long run this measures may strengthen banks' fundamentals. Another risk-limiting measure is that central banks loosened the requirements for banks to borrow cash at low interest rates during the crisis which in turn can lower the funding cost for banks. For example, the ECB eased collateral requirements to help banks pursue their funding operations. Therefore, a reduction of collateral valuation haircuts of 20% is applied and government guaranteed loans with lower credit quality are accepted as collateral. Obtaining cash at lower costs helps banks to carry out its operative activities.

However, there is an increased credit risk, which can be attributed to several circumstances. This crisis hits amid times of weak economic environment when banking profitability was already under pressure due to low interest rates. Further, regulatory measures were successively eased to adapt lending to the current situation. International regulators announced their support for the use of capital buffers and liquidity buffers, which were designed to strengthen lender's balance sheets after the 2008 financial crisis. Now, they are used to serve their purpose – central banks worldwide relieved USD 492bn of capital and the largest proportion comes from these cut buffers, which are expected to provide lenders with the capacity to grant USD 5tn of extra loans to keep credits flowing to business and households. If banks follow the central bank's recommendation and grant more

[1] The NUS-CRI Probability of Default Implied Rating (PDiR) provides a more conventional interpretation of PDs –it translates NUS-CRI 1-year PDs to letter ratings by taking reference from the historical observed default rates of S&P's rating categories.

(risky) loans, this reduces their capability of loss absorption due to shrinking buffers, which increases their credit risk.

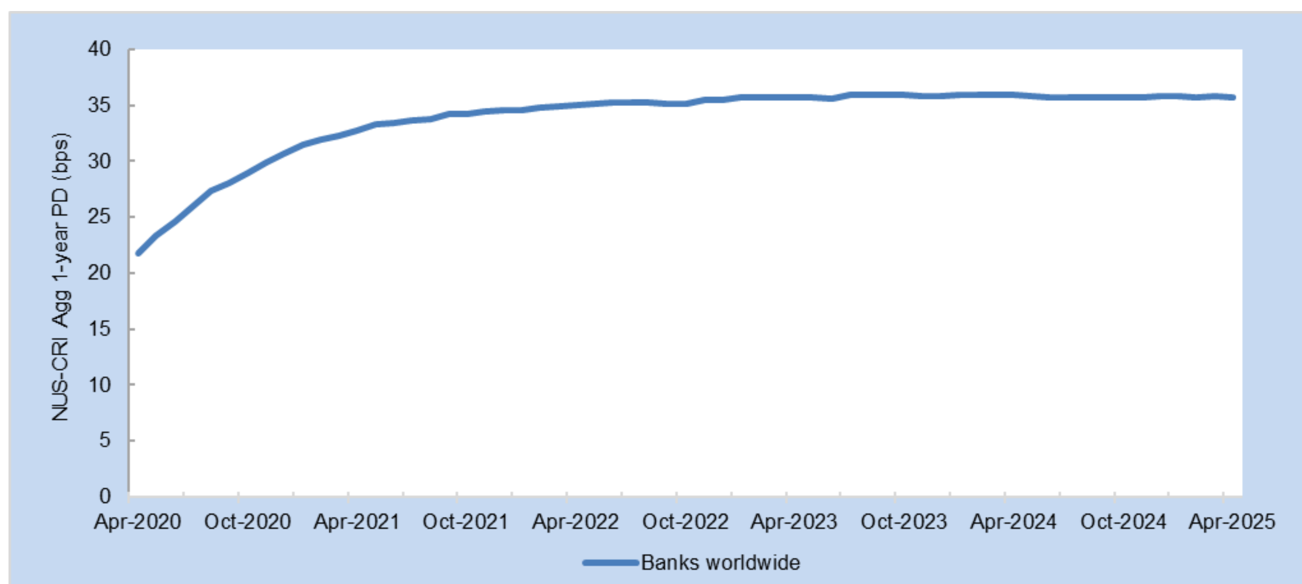

Figure 3: NUS-CRI Aggregate Forward 1-year PD of banks worldwide based on information available in Apr 2020. *Source: NUS-CRI.*

Figure 3 presents the NUS-CRI Aggregate (median) Forward 1-year Probability of Default (Forward PD)[2] of banks worldwide and shows that the market is bearish about next year's credit outlook. In the short run, i.e., within the next year, bank's credit risk is expected to increase by 50% to 32.70bps. In the long run, the Forward PD risk remains mainly stable after surviving Apr 2021, which indicates that the impact of the Covid-19 crisis is limited. Even without considering all the banks that defaulted since 2008 until today, the Agg PD at its peak in Mar 2009 is nearly three times higher than the Forward PD at its prognosed peak in Jul 2021, a relatively comforting message regarding the banking system's credit outlook.

Credit News
Banks have USD 13bn of junk debt they can't wait to sell **Apr 17.** Bonds and loans worth USD13bn collectively were agreed by banks to support acquisition pre-coronavirus outbreak in Europe. However, as the situation worsened, junk bond trading levels dipped and banks have resigned to stump up as much as USD6bn funding themselves so far. This could increase in the coming months as more deals get finalized. Based on the Bloomberg Barclays Pan European Index, junk bond yields have increased from 3.2% to just under 8% in the past two months alone. Making matters more challenging, ratings of many sub-investment grade companies are also being downgraded as revenue falls and liquidity tightens. Their resultant lower ratings make debt raising even more costly for affected firms which could lead to an overall increase in default rates globally. (Bloomberg)
China companies defy stimulus efforts by borrowing to save **Apr 16.** Over the last two months, China's central bank has cut rates and boosted liquidity to encourage banks to lend to firms during the coronavirus pandemic. However, the latest data shows that companies are not using the loans as the central bank would want. The ample liquidity and low borrowing cost have created an arbitrage opportunity for corporates - they are investing the borrowed money in short-term debt and

[2] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similar to a forward interest rate. For example, the 12-month Forward 1-year PD is the probability that the firm defaults during the period from 12 months onwards to 1 year plus 12 months, conditional on the firm's survival in the next 12 months.

deposits that could yield more than twice the rate of their loan. The extra loans are not finding their way into the real economy. (Nikkei Asian Review)

Global oil pact and Fed support boost junk-rated US bond market

Apr 15. The junk-rated US energy bonds rallied by the most in four years on Monday following measures to prop up credit markets by the Fed and an agreement between oil-producing nations to cut production drastically. Despite the rally, the junk energy bonds have remained deep in distress. Many debt-laden energy companies continue to battle for survival facing the weak demand for commodities during the coronavirus outbreak, and an unusually warm US winter, weigh on oil prices. Energy companies have been at the forefront of this year's wave of defaults and junk-rated oil and gas producers have still had trouble securing new funding. (FT)

Private equity-owned companies sell new bonds in credit rally

Apr 15. One week after the Fed announced the expansion of its bond-buying program to include some junk-rated securities, companies owned by private-equity firms are ready to capitalize on a supercharged credit rally. As the coronavirus cases may already be peaking in some European nations, European investors are now showing greater risk appetite. Companies most affected by the virus such as Hilton Worldwide Holdings Inc., continues to tap on the US market. Meanwhile, junk bonds listed in the US market with double digit yields got record weekly inflow of USD7.7bn after the Fed announced its support for some junk bonds. In Europe, Verisure, a company well known to investors, ended the worst European junk sales drought in eight years with its safe, secured offerings. The credit rally provides an opportunity for companies in private equity portfolios to raise funds. (Bloomberg)

China bank balance sheets put to test by coronavirus impact

Apr 14. Chinese banks are at risk of having to set aside billions of dollars more to cover loans that have gone sour due to the coronavirus pandemic. Even before COVID-19, bank balance sheets were already under pressure from the weakening economy and the trade war with the US. According to S&P, the consequences of the coronavirus pandemic could add USD 497bn in nonperforming loans as well as USD 224bn in provision to China's banking system. It would drive up expected losses and force banks to recognize them immediately, eating into their available capital. (Nikkei Asian Review)

India's state borrowers are crowding out cash-strapped companies (Bloomberg)

JCPenney misses bond payment, considers options (FT)

UK banks expect to lend more to business as COVID-19 crisis deepens (Reuters)

Regulatory Updates

India central bank buys bonds in secondary market to cool yields

Apr 18. The Reserve Bank of India bought USD 1.9bn of bonds in the secondary market over three days last week in a bid to cool yields. The purchases are distinct from announced auctions via open market operations and were done anonymously over the electronic trading platform. India's central bank is keen to lower yields to help reduce borrowing costs locally: the central bank has cut its benchmark rate by 75bps last month and the reserve repurchase rate to free up more cash for lending on Friday. After the reverse repo cut, shorter bonds rallied on Friday, while long-end yields fell less on concern over the government's fiscal deficit amid potential higher spending to support growth. (Bloomberg)

China adds liquidity, trims rates ahead of poor GDP data

Apr 15. On 15th April, the People's Bank of China (PBOC) offered CNY 100bn yuan (USD14bn) via the one-year medium-term lending facility, cutting the rate from 3.15% to 2.95%. Previously in late March the central bank had cut the rate on 7-day market operations by 20 basis points and since interest rates often move together, the new reduction is much anticipated by market players. Moreover, a cut of 50 basis points to the bank's reserve ratio also releases CNY 200bn yuan of funding. These counter-cyclical easing measures were taken right before China releases its 2020Q1 economic data, inclusive of its GDP which is expected to be its worst results in decades. The two-step reduction will free up CNY 400bn of liquidity in the financial system and suggests that the PBOC is flexible to support the economy. Overall, the operation may help to counter the news of the nation's GDP shrink in the first quarter**.** (Bloomberg)

Turkey announces new regulation to boost lending, bond purchase (Bloomberg)

Bank of Russia hints at big rate cut to prop up crashing economy (Bloomberg)

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