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

Transforming Big Data into Smart Data

Weekly Credit Brief Apr 29 - May 05 2014

<u>Chart of the week</u>

<u>Italian banks prepare for stress tests</u>

The extensive process of Italian banks' balance sheet repair began in late 2012, as the risks from Europe's sovereign debt crisis ebbed away. The improvement continued through 2013 as Europe's economic climate improved and lending increased. In 2014, the repair has gathered fresh momentum ahead of European Banking Authority's EU-wide stress test. The same is evident in Figure 1 below, showing 1-year RMI probabilities of default (PD) for the three largest banks of Italy by assets – UniCredit SpA, Intesa Sanpaolo SpA and Banca Monte dei Paschi. The 1-year RMI PD for Intesa, UniCredit and Monte dei Paschi dropped 6.5bps, 7bps and 70bps in Q1 2014. Their current PDs are at 7bps, 24bps and 70bps respectively.

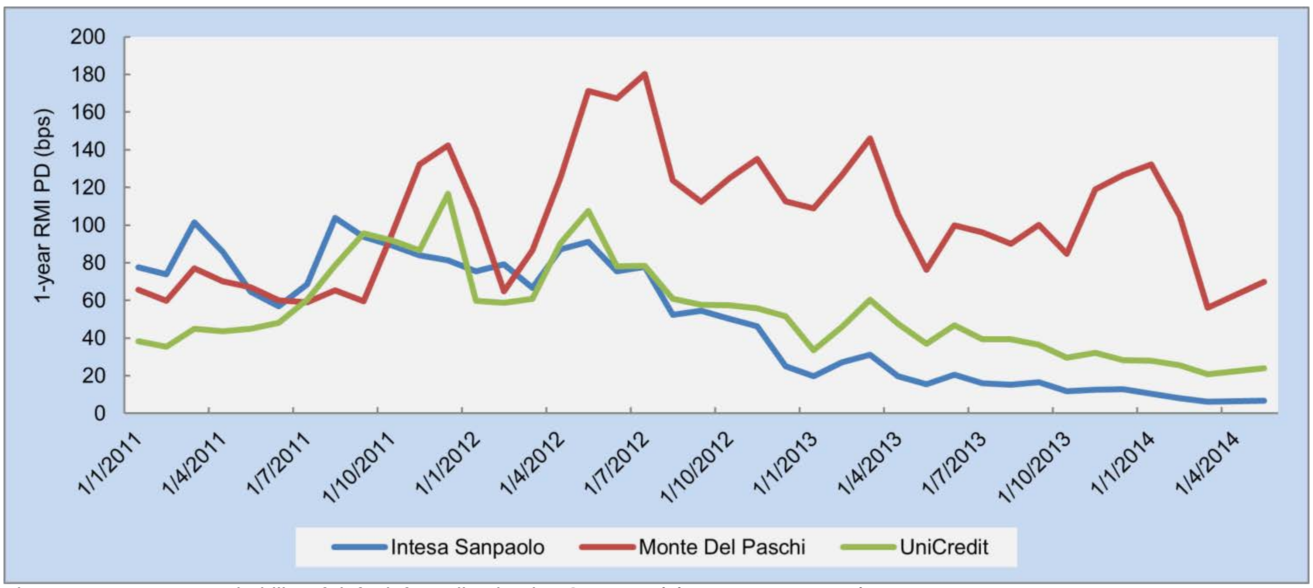

Figure 1: 1-year RMI probability of default for Italian banks. *Source: Risk Management Institute*

In the run-up to Europe's stress tests all of Italy's banks are scrambling to improve their capital strength. During these stress tests, 124 banks will be put to the test from the 28 EU countries, and will have to prove that they still have enough capital given theoretical shock-scenarios. Italian banks will have to show that they can survive simultaneous routs in bonds, property and stock. UniCredit SpA and Intesa Sanpaolo SpA have both also signed a contract with U.S. private equity firm KKR and restructuring adviser Alvarez & Marsal to reorganize a part of their bad debts. The third biggest Italian bank, Monte dei Paschi plans to issue EUR5bn of new shares to get access to fresh capital to pay off part of the government loan it took last year to plug a capital shortfall.

Better capitalization and good stock performance have clearly worked to the banks' advantage. Monte dei Paschi, UniCredit and Intesa stocks have made year-to-date gains of 40%, 19% and 37% respectively. In Q1 2014, UniCredit's distance-to-default 12-month moving average (DTD moving average) went up from 0.22 to 0.39, Intesa's DTD also increased from 2.18 to 2.43. Monte dei Paschi's DTD however is still negative improving only marginally from -1.12 in the beginning of 2014 to -1.07 currently. DTD is a volatility-adjusted measure of a firm's leverage, with numbers close to or below zero suggesting potential insolvency.

The strict capital regulations have also contributed significantly to achieve the low levels of PD. In the annual reports for the financial year 2013, UniCredit highlights that it improved its core tier 1 ratio significantly. Intesa kept the core tier 1 ratio at last year's level, fulfilling current regulatory requirements while Monte dei Paschi increased its tier 1 ratio from 13.2% to 13.5%. The massive cleanup of bad loans however has caused these banks to struggle with their profitability. All three of the banks reported annual losses of more than EUR1bn for 2013. As such, while the worst seems behind and stock prices bottom out, the fate of the Italian banks remains contingent on a broad based European recovery.

Credit News

Portugal decides on 'clean exit' from bailout

May 04. Portugal is set to become the second eurozone nation after Ireland to exit bailout. Prime Minister Pedro Passos Coelho announced that the country would end the assistance program without a precautionary credit line. Portugal has made significant strides towards economic recovery since being bailed out in 2011, with economic activity turning positive last year and 10-year sovereign yields recently dropping close to an 8-year low. (Reuters)

Australia central bank seen on hold even as tough budget looms

May 04. Australia's central bank is almost certain to maintain a neutral policy bias in its quarterly monetary policy announcement on May 9, with data likely to point to an economy picking up speed. All 25 economists polled by Reuters expect the Reserve Bank of Australia (RBA) to hold its cash rate steady at a record low of 2.5% and reiterate its commitment to keep interest rates unchanged. Retail sales, which account for about 17% of Australia's GDP and employ 10% of the workforce, have been growing robustly for the past 11 months; and are expected to have grown 1.5% in Q1 2014.Healthy retail sales auger well for a rebound in the labour market as well after a disappointing 2013. (Reuters)

China's property developers' default risk poses funding threat

May 01. The collapse of Zhejiang Xingrun Real Estate will make it harder for property developers in mainland China to raise funds. Influenced by its default, Chinese developers have cut down the issuance of offshore CNY or USD bonds in April to USD 500mn from USD 1.6bn in the same period last year. Additionally, six of the ten worst Chinese corporate bond performers in April were property bonds. China's property sector has suffered recently, with the price of property securities slumping 4.9% in the past year, and property sales falling 5.2% in Q1 from a year earlier. With China experiencing its weakest GDP growth in six quarters, investors are becoming increasingly concerned that more developers will default. (South China Morning Post)

Fed's Fisher says economy strengthening as payrolls rise (Bloomberg)

Korea's central bank shows narrowing output gap (Arirang)

India's monetary easing may be delayed until early 2015 (Hindu Business Line)

Regulatory Updates

Yellen says Fed seeking smarter oversight of community banks

May 01. Fed Chairman Yellen said that small US banks should not face the same regulatory pressure as the largest financial institutions as the Federal Reserve is aiming to reduce the regulatory burden for small US banks. Executives at banks say that lenders with less than USD 10bn in assets are finding it a challenge to adapt to the newly instated regulatory rules under the Dodd Frank Act. Some of the community banks and representatives of the Senate have called for a representative of small banks to be nominated to the Fed's Board of Governors. The Fed said that community banks share the interest in reducing the systemic risk posed by large, complex and interconnected banks and would study the benefits and costs of making specific policies which cater to community banks. (Bloomberg)

Bank of England publishes details of UK stress test for major UK banks and building societies

Apr 29. The Bank of England will conduct a stress test for UK lenders to explore any macroeconomic vulnerabilities facing the UK banking system. The UK variant test will be built upon the EBA's 2014 stress test and will examine the resilience of UK banks and building societies under a housing market shock scenario where there is a sharp rise in both short and long term interest rates. The scenario starts in Q1 2014 and extends through to Q4 2016, where it is initially characterized by a 30% decline in the GBP against the USD during the first year. In addition, the Bank of England will also assess the projections of the banks' profitability and capital ratios under a baseline macroeconomic scenario and assuming a dynamic balance sheet definition so that the size and composition of the banks' balance sheets are allowed to vary over the projected horizon. (Bank of England)

The Securities and Exchange Board of India proposes new listing and disclosure requirements

Apr 29. The Securities and Exchange Board of India (SEBI) proposed draft rules for greater transparency on listed companies and also proposed to give the stock exchange greater powers to deal with firms who do not comply with the new laws. The newly proposed regulations will replace existing provisions for listing agreements, which will include imposing corporate fines, suspension of trades and freezing shareholders' accounts. The new regulation also lists a new corporate governance framework such as requiring companies to get shareholder's approval for related party transactions, elaborate disclosures on pay packages and keep at least one woman director on company boards. The industry has until the end of May to comment on the SEBI's intentions for listed firms. (Economic Times)

Bank of Italy says that the Italian banks' bad loan problem is easing (Reuters)

Published weekly by Risk Management Institute, NUS | Disclaimer
Contributing Editor: Chiranjiv Sawhney