Credit Research Initiative

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Weekly Credit Brief August 05 - August 11

African Bank goes under central bank's curatorship amidst mounting credit losses

By Siddharth Batra

African Bank Investments Ltd. (ABIL), the largest unsecured lender in South Africa advancing loans without the backing of a mortgage or security came to the brink of collapse on Aug 8. ABIL's stock sank 93% and the yield on the bank's ZAR 350mn February-2017 maturity bonds surged to 19.2% during a 3-day period i.e. 6-8 Aug. The drop necessitated the intervention of South African Reserve Bank (SARB) to step in to restructure the bank by placing ABIL under curatorship and ensure the stability of South Africa's financial system.

In Mar 2013, South Africa's National Credit Regulator (NCR) probed and alleged reckless lending practices at ABIL, deep problems at the bank were confirmed recently on Aug 6, 2014 when it announced that its founder and CEO Leon Kirkinis is stepping down. The disclosure corroborated that ABIL was staring at a capital crisis - bracing for a record loss of ZAR 7.6bn in 2014, it needs another capital injection of ZAR 8.5bn, after raising ZAR 5.5bn in Dec 2013 to fund rising bad debts as also to plug losses at its furniture retail unit.

The market capitalization of the bank collapsed from a YTD high of ZAR 13.6bn on Apr 30 2014 to ZAR 340mn on Aug 8. The 1-Year Probability of Default (1Y RMI PD) of ABIL, rose from 76.5bps on Jul 31 2013 to 163.4bps on July 31 2014 indicating the deteriorating capital position and mounting losses. Since the management disclosure on Aug 6, the 1Y RMI PD shot to 1499bps or 15% on Aug 8.

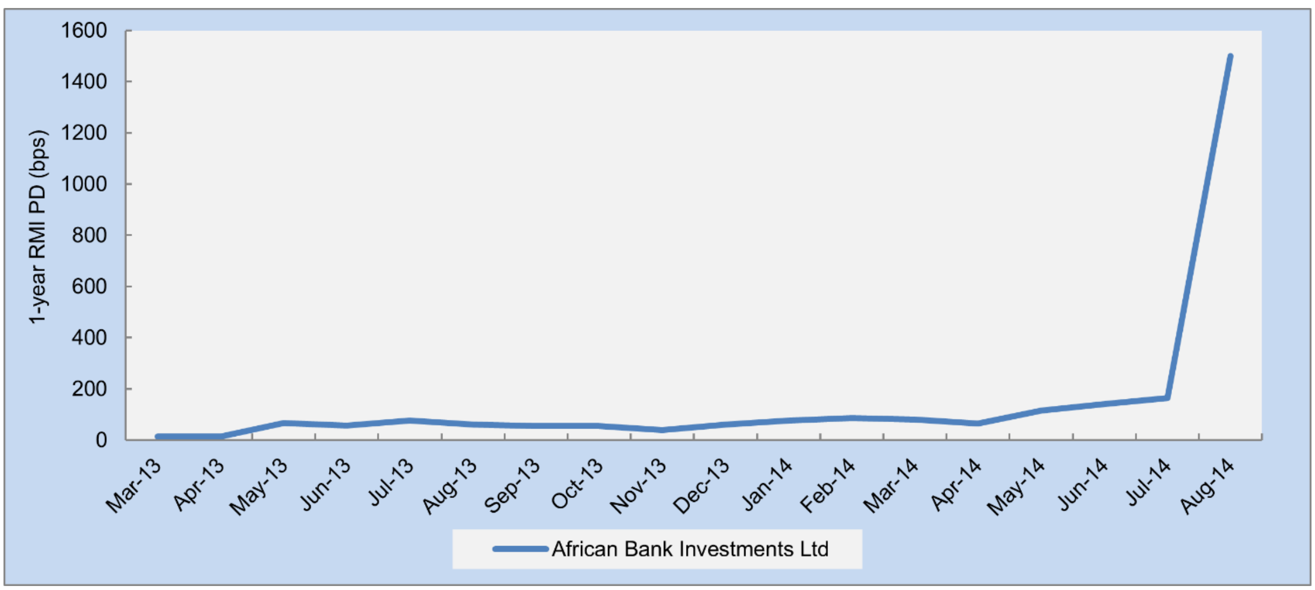


Chart 1: 1-Year RMI PD of African Bank Investments Ltd. (ABIL) Source: *Risk Management Institute*

At the same time, 3-year RMI Actuarial Spread (AS) - a pure measure of default risk, and is not influenced by risk premium and market liquidity, rose from 81bps to 502bps indicating the heightened risk wariness of investors. The AS is based on the assumption of a 40% recovery rate as compared to the yield of its 8 1/8% 5-year USD 350mn notes maturing in Feb 2017 as displayed in Chart 2.

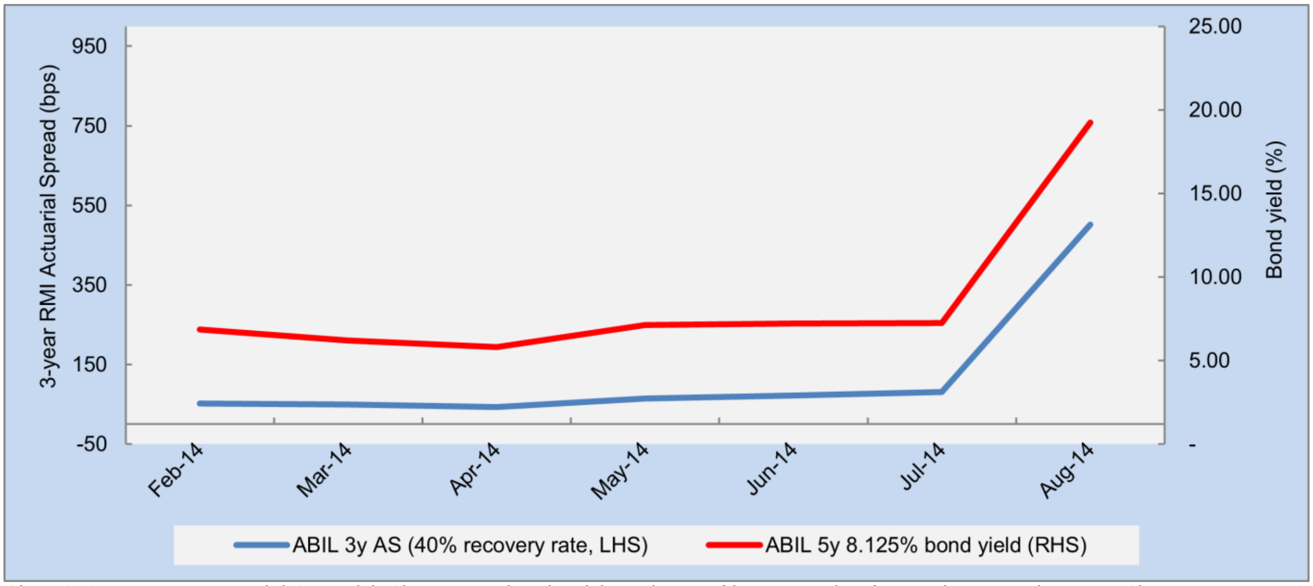
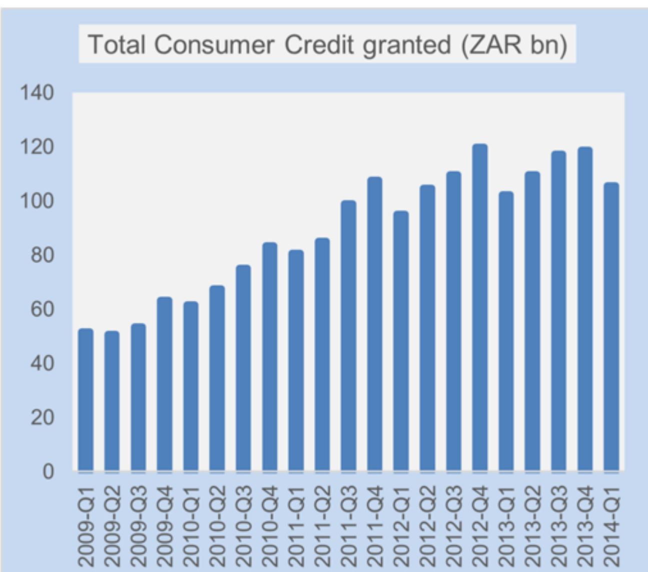


Chart 2: 3-Year RMI Actuarial Spread (AS) representing the risk wariness of investors shot from 81bps on Jul 31 to 502bps on Aug 8. USD 350mn 5-Year February-2017 bond yield increased to 19.2%. Source: *Risk Management Institute, Bloomberg*

Primary reason for ABIL's travails is its risky business model. ABIL is not a deposit-taking bank and raises capital through debt and equity issuances. It functions with virtually no business diversification, disbursing small ticket loans to low-income earners without the backing of any asset or mortgage. Such unsecured lending has witnessed a bubble of sorts in South Africa in recent years, as per the National Credit Regulator (NCR) – exploding from ZAR 51bn in Dec 2008 to ZAR 119bn by Dec 2013, and ABIL has had the lion's share of this aggressive lending spree with obviously lax underwriting standards. ABIL had a 23% market share of all Consumer Credit advanced in South Africa in H2/2009, and did not slow fast enough even as the economy soured and competition withdrew – ending H2/2013 with close to 25% market share.



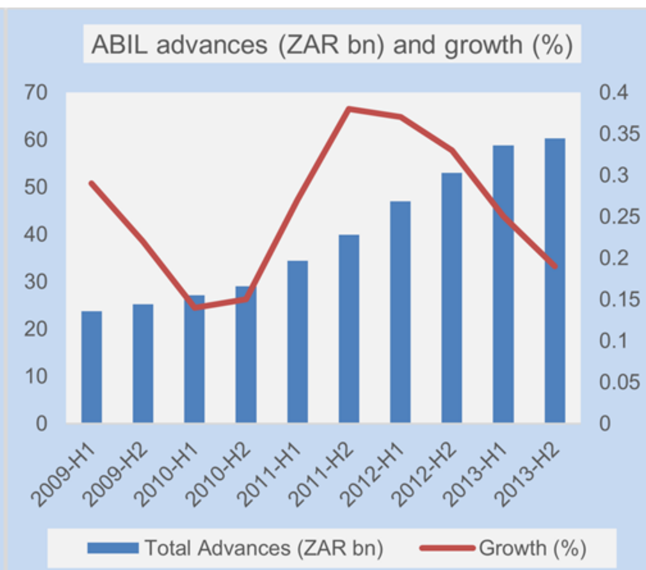


Chart 3: Total Consumer Credit in South Africa has expanded rapidly in recent years and ABIL has been the most aggressive lender in unsecured credit. Source: *National Credit Regulator (NCR), South Africa*

Moreover, the predominant exposure to the most vulnerable section in society left ABIL highly susceptible to any economic distress that would hamper the repaying ability of its borrowers. With a slowing South African economy (Q1/2014 GDP of -0.6%), unemployment at a record 25% and accelerating inflation (6.6% in Jul 2014), many of ABIL's customers are struggling to keep up with repayments and credit losses have mounted. ABIL's NII/Avg. RWA contracted from 16.5% in 2011 to 14.9% as of Mar 2014. With massive pileup of delinquencies from 34.2% to 40.0%, Credit Costs/PPOP jumped from 50.7% in 2011 to 161% as of Mar 2014 signaling severe stress building up in the books. ABIL's Tier 1 capital adequacy deteriorated acutely in 2013 until it could raise fresh equity.

Profitability, Asset Quality & Capital position (%)	2010	2011	2012	2013	Mar 2014
Net Interest Income/ Avg Risk-weighted Assets	NA	16.5%	17.3%	17.3%	14.9%
Net Interest Margin	NA	13.2%	13.6%	13.5%	11.6%
Return on Avg Risk-weighted Assets	NA	8.2%	8.3%	-9.4%	-17.7%
Problem Loans/ Risk-weighted Assets	35.2%	34.2%	36.1%	34.8%	40.0%
Credit Costs/ Pre-Provision Op. Profit	48.7%	50.7%	52.3%	93.2%	161.0%
Capital Adequacy (Tier I)	28.9%	30.4%	29.0%	15.7%	19.0%

Chart 4: ABIL saw a massive buildup of credit cost as delinquencies increased. Margins and returns compressed and capital position worsened. Source: *SNL Financial*

The effects of economic slowdown are showing up systemically and the troubles besetting the consumer credit business in the domestic economy is worrisome. For the unsecured lending industry as a whole, close to 30% of loans are 30 days or more past due (DPD), while 19% of loans are in default, i.e. 120 DPD as of Mar 2014. The NCR data also points out that nearly 27% (or 2.23mn) of the 8.3m active unsecured loan clients have effectively defaulted or are 120 Days Past Due as of Q1/2014.

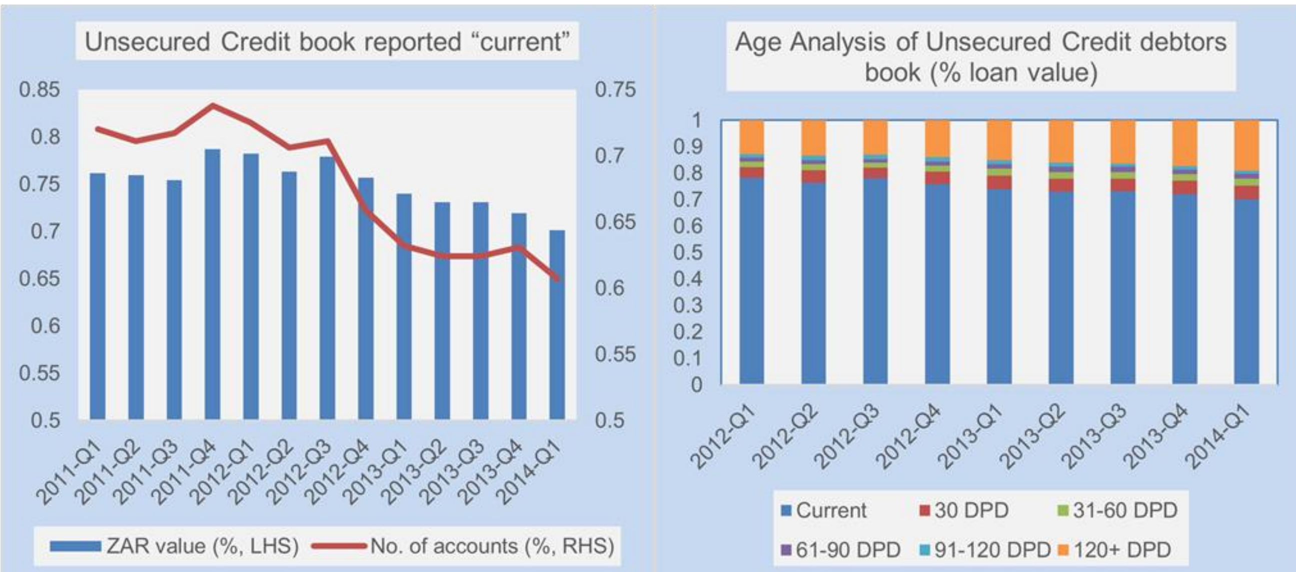


Chart 5: Slowing economy has led to a systemic increase in problem loans. Only 70% of unsecured loans are current and 19% have already defaulted (>120 DPD). Source: *National Credit Regulator (NCR), South Africa*

The other reason for ABIL's downfall is self-inflicted. In the hope of acquiring new retail clients and boost lending, ABIL acquired a furniture retail business - Ellerine Holdings (EHL), in 2008 for ZAR 9.2bn, but it proved disastrous and a huge drain on resources due to losses and massive write-downs – ZAR 5.7bn was written down in Sep 2010, and ZAR 4.6bn impairment charges was taken in Oct 2012. ABIL post restructuring will cease to fund the still loss-making EHL business and is now seeking to exit the unrelated business altogether.

In the restructuring measures announced by the South African Reserve Bank (SARB) on Aug 10, it placed ABIL under curatorship to help the bank survive by ring-fencing the good loans from bad loans. The bad book marked down to ZAR 17bn will be bought over by SARB for ZAR 7bn, while the good book valued at ZAR 26bn will be recapitalized by additional ZAR 10bn.

Credit News

Argentina calls for US intervention in its debt battle

Aug 11. Argentina called on the US government to intervene in the country's court case against hedge funds over defaulted debt, after US Judge Thomas Griesa said he would issue a contempt of court order against the Argentine government. Argentina said that the country had met its obligation to the holders of restructured bonds when it deposited USD 539mn in an intermediary bank in June, but Judge Griesa called the deposit illegal and ordered the money frozen. (Reuters)

LCY Chemical plunges as court approves provisional attachment order

Aug 09. The market cap of Taiwan listed firm LCY Chemical plunged more than 39% since the start of August after the company was held responsible for the deadly gas explosion that staggered Kaohsiung. The stock had triggered the exchange's daily decline limit of 7% for seven consecutive sessions during the month. The District Court recently approved an attachment order against the company to prevent the firm from moving its asset to avoid possible compensation payments to the victims of the blasts. (Focus Taiwan News)

Russian sanctions hit Norwegian firms

Aug 07. Russia retaliated against Western economic sanctions with import bans on fish and other food products, depriving the Norwegian salmon producers of their third-biggest export market which contributed to over 9% of Norway's export revenue in July and leading to a record 9.3% plunge in Oslo's 13-member Seafood Index. According to some analysts, if Russia imposes a full year ban on salmon imports, global demand could be reduced by 7%, leading to a 14% increase in price. In addition, the Russian Agriculture Minister revealed that Russia would search for alternative red fish suppliers both domestically and internationally to replace Norway. (Bloomberg)

Chinese banks get serious about risk as bad debts swell

Aug 07. Chinese banks are scrambling to halt the rate of growth of bad debt in the country after the average bad-loan ratio for Chinese commercial banks reached a three-year high of 1.08% in June. Chinese banks have reduced lending to private firms and have become more diligent in assessing risk. The cut back in lending could have a negative impact on China's near-term economic prospects as consumption falls and the service sector contracts. (Reuters)

South Korean banks' bad loan ratio falls in Q2

Aug 05. The combined bad loan ratio of 18 South Korean banks stood at 1.71% at the end of June, down 0.1 percentage point from the previous quarter. Compared with a year earlier, the banks' bad loan ratio slid 0.02 percentage point. The QoQ decline comes after the banks wrote off more debts than they added during the April-June period, with KRW 5.6tn of fresh bad loans offset by KRW 6.7tn of cleared debts. (Globalpost)

Moody's downgrades outlook for UK banking sector to negative (The Guardian)

Japanese lenders seek out riskier borrowers (WSJ)

US high yield bond funds see shocking USD 7.1bn cash outflow (Forbes)

Regulatory Updates

China FX option reform to improve corporate risk management

Aug 06. China's State Administration of Foreign Exchange have relaxed rules to allow local onshore corporates to sell foreign exchange (FX) options to hedge their FX exposures starting from August 1, enabling them to use a combination of options such as call or put spreads in risk management. Previously, onshore corporate could only use forwards and long only options to hedge, which discouraged the use of options due to high hedging costs. (Risk.net)

Fed and FDIC fault big banks' 'living wills'

Aug 06. The Federal Deposit Insurance Corp. (FDIC) said that living wills submitted by 11 big banks including Bank of America, Bank of New York Mellon, Barclays, Citigroup, Credit Suisse, Deutsche Bank, Goldman Sachs, JPMorgan Chase, Morgan Stanley, State Street and UBS as required by the Dodd-Frank financial reforms were "not credible", as they made unrealistic assumptions and failed to identify necessary changes in their structure. Consequently, big banks were required to revise their plans by July 1, 2015 and take actions such as simplifying their legal structure so that they would be able to wind down more easily in case of crisis. (CNBC)

Malaysian banks with Indonesian subsidiaries can face more hurdles

Aug 05. Malaysian banks with Indonesian subsidiaries could face more hurdles in expanding their businesses when a law to cap foreign ownership to 40% takes effect between now and October. Both Malayan Banking Bhd and CIMB Group Holdings Bhd have over 40% ownership on its Indonesian subsidiaries whose contributions are 7% and 30% to its parent's earnings now. Industry observers and analysts opined that although there could be dilution of stakes if the restorative banking law were to be enacted, but Malayan Bank and CIMB Group would still operate in Indonesia, as there are long-term growth prospects in the country. (The Star Online)

ESMA outlines fee hike for credit rating agencies (eFinancialNews)

Ginnie Mae reviews rules for services as nonbanks expand (Bloomberg)

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