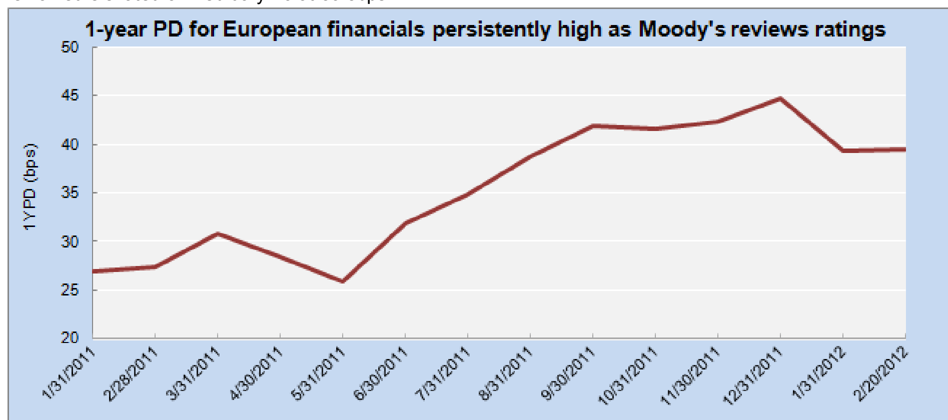
Stories of the Week

Negative credit outlook continues for European financial firms

Despite the supportive stance by the European Central Bank (ECB), the credit outlook for European financial firms continues to be downbeat due to the persistent European sovereign debt crisis. The RMI CRI 1-year probability of default (PD) for European firms declined from a high of 44.8bps at the end of last December, but remained elevated on February 20 at 39.5bps.



Meanwhile, Moody's warned on February 15 that 114 financial institutions in 16 European countries may face credit rating downgrades. In addition, 17 global banks including Bank of America and Citigroup were among Moody's warning list for credit rating downgrades.

Moody's warning reflects the ongoing challenges facing European financial firms and the fallout of the European sovereign debt crisis beyond the region. European financial firms and other banks with global capital market operations are facing pressures from weakening funding conditions, increasing regulatory obligations and a tougher operating environment. Compounding the problems for European financial firms are the negative impacts from deteriorating European sovereign credit ratings, which could weigh on the firms' sovereign exposures and operations. Moody's cut the sovereign credit ratings of Italy, Portugal, Spain, Slovakia, Slovenia and Malta on February 13.

Sources:

Moody's Reviews Ratings for European Banks (Moody's)

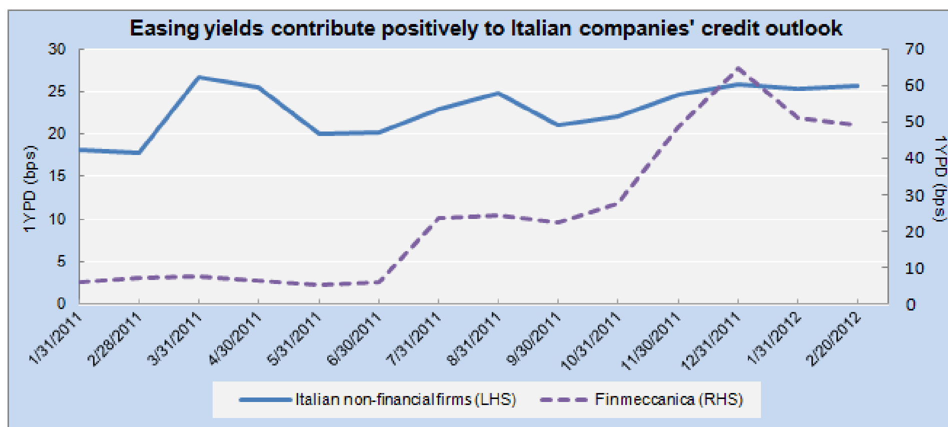
Moody's says may downgrade 17 global banks, securities firms (Retuers)

Renewed investor confidence led to rebounds in Italian bonds despite Moody's downgrade

Italy's sovereign and company debt market rebounded this year, despite a two-notch downgrade of the Italian sovereign rating to BBB+ by S&P on January 14 and a one-notch cut to A3 by Moody's on February 13. Italy's 10-year government bond yield declined to 5.6% on February 17, from a high of 7.1% in early January. The credit spread between Italian non-financial companies and the Italian sovereign narrowed to 288bps in February, from 377bps at the end of December, Bank of America Merrill Lynch data shows. Bonds issued by Finmeccanica SpA, Italy's largest defense company, outperformed all other securities tracked by the Markit iBoxx Euro Non-Financials index, and prices have increased 25% since the start of the year.

The rally in Italian bond markets in recent months was supported by renewed investor confidence after the Italian government approved EUR20bn in budget cuts and tax increases last December, as well as the longer-term refinancing operation by the ECB in the same month.

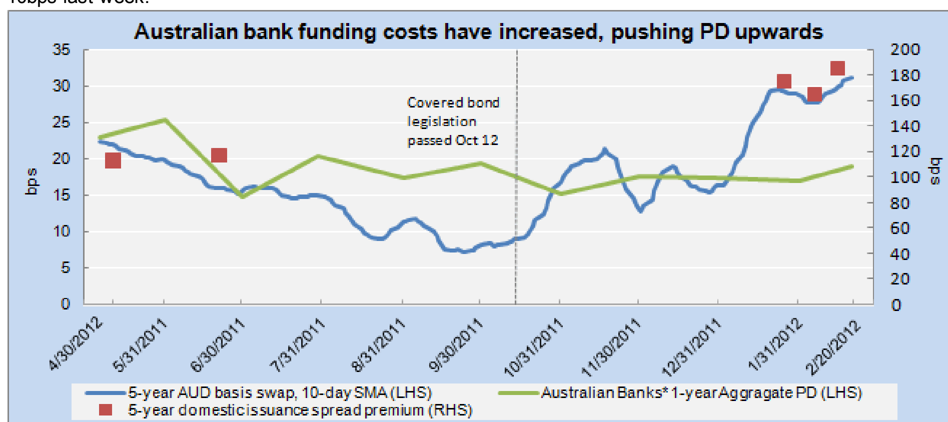
Easing yields for Italian non-financial companies contribute positively to their credit outlook, due to lower refinancing costs. The 1-year PD for Italian non-financial companies has stayed relatively flat at around 26bps since the end of last December. The 1-year PD for Finmeccanica SpA fell to 49.1bps on February 20 from 64.5bps at the end of December.



Sources:
Italian Company Bond Performance Rebounds to First From Worst (Bloomberg)

Increased Funding Costs Place Upwards Pressure on Australian Bank PD

The 1-year PD for Australia's largest banks trended upwards last week, as funding pressures mounted. All four major Australian banks* increased their key retail interest rates in the last fortnight, independent of cash rates set by the Reserve Bank of Australia (RBA), to reflect increased funding costs. The Australian banking industry believes that retail rates should reflect changes in deposit and wholesale funding costs, and not be dependent on the RBA cash rate, which was reduced 50bps to 4.25% in Q4. Increases in retail interest rates by the four banks have not offset increased funding costs, placing upwards pressure on the aggregate 1-year PD for Australian banks. ANZ stated that it is absorbing 14bps of increased funding costs, to reduce the impact on customers. The Commonwealth Bank said it was making a loss on new loans before it increased retail lending rates by 10bps last week.



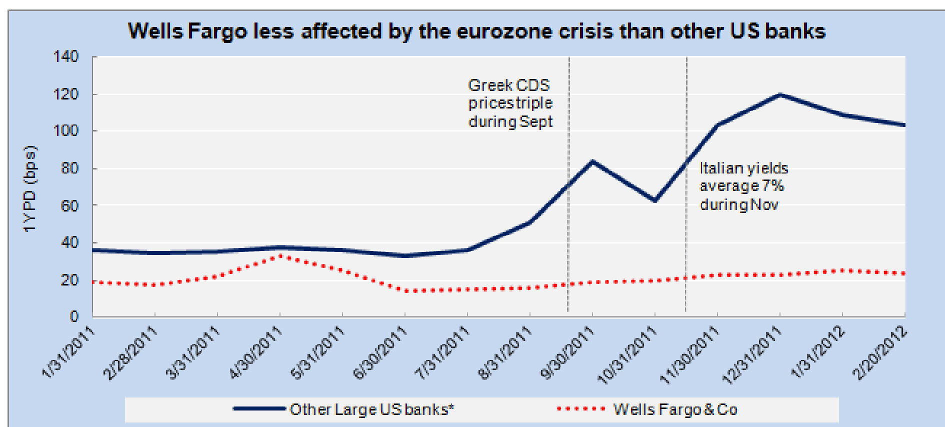
Five-year domestic bond issuances by the National Australia Bank infer that yield premiums on Australian bank bonds have increased by around 68bps since July 2011. The cost of converting foreign bond issuance into AUD has risen dramatically since the beginning of 2012. The appreciation of the AUD in recent months has deterred kangaroo bond issuance, pushing the AUD basis swap upwards. Issuances of covered bonds by Australian banks since legislative changes in October have placed additional upwards pressure on the AUD basis swap. Covered bonds have not significantly decreased Australian bank funding costs, as recent issuances have priced at similar rates to senior unsecured domestic bonds. Australian banks may need up to AUD100bn in funding this year to meet demand for credit in Australia. Consumer and business confidence is high as Australian economic growth remains strong, due to Chinese and Indian demand for the country's resources.

*ANZ, Commonwealth Bank, National Australia Bank, Westpac. (Excludes regional banks)

Sources:
ANZ warns rates could rise again as cost pressure continue (The Australian)
Commonwealth Bank's New Loans Are Profitable, Chief Executive Narev Says (Bloomberg)

Wells Fargo Default Risk Remains Well Below Peers

According to RMI CRI data, the 1-year PD for Wells Fargo has remained significantly lower than the PDs of the company's domestic peers. Modest improvements in US employment and household spending in recent months have benefitted the US focused lender, which now originates 30% of new US mortgages. The company has experienced the lowest litigation costs associated with faulty mortgages and shady foreclosure practices amongst US lenders.



Wells Fargo also has relatively low exposures to sovereign risk compared to other large US banks, with the company's PD remaining relatively stable during the depths of the eurozone crisis last year. The bank should also be less affected by the Volcker Rule when it comes into effect, as the company has a smaller presence in capital markets. Wells Fargo was the only large US bank not put under review for downgrade by Moody's last week.

* Bank of America, CitiGroup, Goldman Sachs, JPMorgan Chase & Morgan Stanley

Sources:
Wells Fargo Breaks From Pack in Swaps (Bloomberg)
Bad Home Loans Top USD72 Billion in 'Colossal Failure' (Bloomberg)

In the News
Toxic? Says Who? Taste For 'Subprime' Returns Feb 16 - Positive sentiments towards the recovering US property market and the stabilizing eurozone have renewed investors appetite for mortgage backed bonds. ABX, an index for credit default swaps that track subprime debt, is up 14% this year. This follows a 30% decline in 2011. (WSJ)
China Cuts Reserve-Ratio for Growth as Inflation Deters Interest-Rate Move Feb 20 - The People's Bank of China announced a 0.5% reduction in reserve requirements for Chinese banks, effective February 24. This is aimed at encouraging lending and promoting economic growth, as China's housing market declines and the European sovereign debt crisis affects exports. A 0.5% cut is expected to add $63bn to the Chinese financial system. (Bloomberg)
Capital support assured for public sector banks Feb 19 - The Indian government stated it is ready to infuse public sector banks with new capital to help them comply with Basel III capital regulations. The state plans to have all public sector banks meet a minimum of 8% Tier I capital, more than the 6% Tier 1 Capital ratio mandated by the Reserve Bank of India and the Basel III Accord. (TheHinduBusinessLine)
ECB Concludes Greek Bond Exchange Feb 17 - €50bn of Greek bonds held by the ECB under its bond purchase program will be protected from losses, after the central bank completed a swap for new bonds that are exempt from collective action clauses. The new bonds have identical structure and face value to the old bonds they replace. (WSJ)
China to allow securitization on local government debt Feb 17 - China may allow banks to securitize their portfolios of local government loans in order to reduce systemic risk in the banking sector. Chinese regulators have frowned upon banks securitizing their assets since the US subprime mortgage process; the central bank last week said it would encourage "safe, simple and appropriate" financial securities. (Reuters)