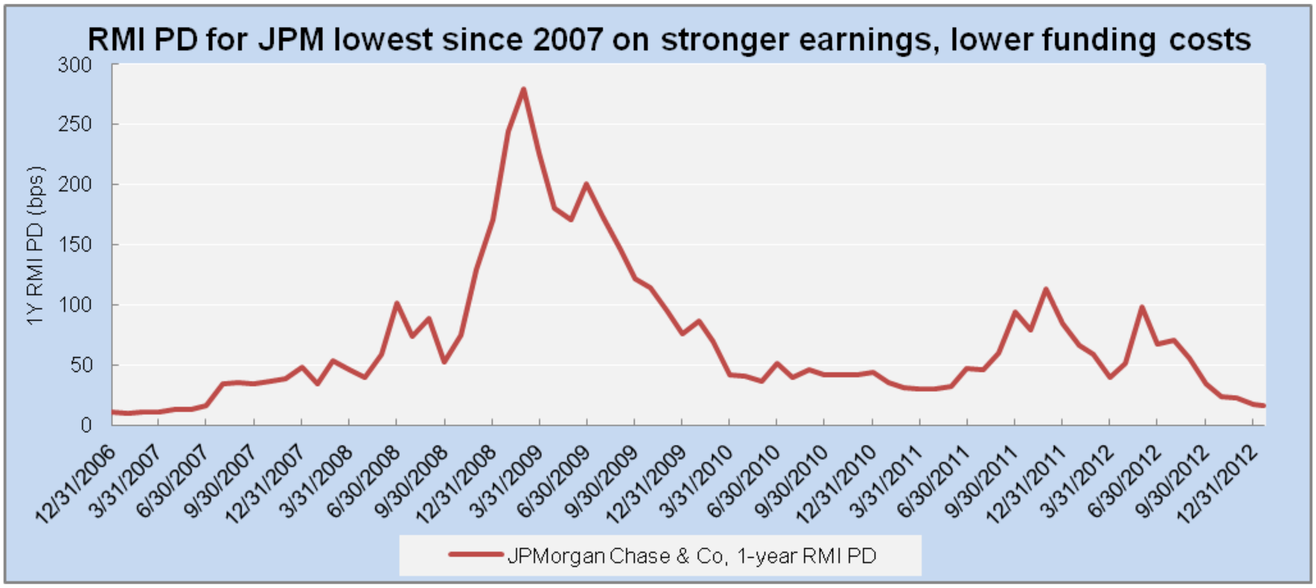
Weekly Credit Brief
Jan 15 - Jan 21 2013

Story of the Week

RMI PD for JPMorgan falls on record earnings, lower funding costs
By James Weston

Both RMI probability of default (PD) data and bond markets are suggesting that markets have forgiven JPMorgan Chase & Co (JPM) for the USD 6.2bn trading loss it recorded last year. The 1-year RMI PD for JPM fell to the lowest level in over five years on January 21, after the bank last week announced record earnings for 2012 and released a report focusing on the trading loss in early 2012. In addition, the bank sold USD 6bn of debt securities on January 18 at the cheapest borrowing costs the firm has ever seen. The debt sale was the largest since the lender sold USD 7.2bn of bonds in April 2011.



Record Earnings: In the bank's latest earnings call on January 16, management reported Q4 net income of USD 5.7bn, on revenues of USD 24.4bn, which increased 10% year-on-year. Net income for the full year was USD 21.3bn, on revenues of USD 100bn. Management cited strong revenues in the investment bank and improved credit quality across corporate loan portfolios and the bank's US housing business as primary drivers of record results through Q4. Moreover, ongoing earnings strength and diversification across a broad number of business lines and geographies appears to allow the bank to shrug off various crises, as it did between 2007 and 2008.

Funding Costs & Capital: Earnings should be supported going forward by record low funding costs the bank is currently locking in, which are primarily driven by the US Federal Reserves' unprecedented loose monetary policy. On January 17, JPM sold USD 1.75bn of 5-year bonds with a 1.8% coupon, a spread of 103bps over similar US Treasuries, USD 2.75bn of 10-year bonds with a coupon of 3.2%, at a spread of 133bps, and USD 2.4bn of 5-year bonds at LIBOR + 90bps. The bank now has USD 250bn of unsecured debt and USD 200bn of equity. According to management, this is more than sufficient to meet a majority of incoming regulation, and a large buffer to protect senior investors from tail losses, such as the CIO trading loss.

CIO Report: The Task Force Report released last week detailed the causes and events leading up to the firm's USD 6bn trading loss last year in the bank's Chief Investment Office (CIO). The loss was caused by an investment strategy involving credit derivatives that JPM CEO Jamie Dimon described as "flawed, complex, poorly reviewed, poorly executed and poorly maintained." Traders in the CIO began taking positions in more complex credit instruments then the high quality bonds the CIO traditionally invested in.

While the risk-appetite of the CIO increased, shortfalls in monitoring and controlling the portfolio occurred. Moreover, JPM's much vaunted risk management structures and processes were not extended to the CIO, and executives within the CIO were allowed to make use of a poorly implemented value at risk (VaR) model that helped the CIO bring VaR below prescribed limits. This allowed traders in the CIO further increase the size and complexity of their positions, which fueled a USD 6bn loss when the markets moved against the CIO.

The remedial measures detailed in the report, a majority of which have already been implemented, are largely credit positive. A large part of the CIO management team has been replaced with an experienced leadership team, and the traders responsible for the losses have been dismissed. The bank has also overhauled the oversight and integration of the CIO. The CIO's synthetic credit portfolio has been transferred to JPM's Corporate and Investment Bank (CIB), which has extensive experience managing such instruments. According to senior JPM management, the CIB continues to reduce and derisk the position.

Sources:
JPMorgan Bond Reduces Whale to Teapot Tempest (Bloomberg)
Report of JPM Management Task Force Regarding 2012 CIO Losses (JPMorgan Chase & Co)
JPM Fourth Quarter 2012 Financial Results Conference Call (JPMorgan Chase & Co)

In the News

Spanish bank bad loans ratio jumps to 11.38% as slump deepens

Jan 18. The proportion of bad loans to total lending at Spanish banks has increased to a record 11.38% in November from 11.23% in October. The total amount of defaults rose to EUR 191.6bn during the month as the number of individuals and companies unable to fulfill their loan payments increased. Bank lending meanwhile declined 0.3% in November from the previous month and 5.7% from a year ago. The Spanish economy is expected to contract 1.5% in 2013 and 1.4% in 2012, according to a Bloomberg poll of 38 economists. (Bloomberg)

Default alarm rings as trust loans jump sevenfold

Jan 17. A sevenfold increase in the amount of trust loans issued in December has forced regulators to take precaution against the risk of defaults. The People's Bank of China recently announced a new policy objective of mitigating risk, which is to seek stable and appropriate growth in loans, stocks and bond issuances. On January 14, China's Banking Regulatory Commission banned unauthorized banks from selling wealth management and private equity related investment products or warned against misleading customers into buying into such instruments. (Bloomberg)

Nearly USD 1tr of debt at risk of downgrade to junk in 2012: S&P

Jan 16. Credit rating agency Standard & Poor's (S&P) said that the amount of debt it could downgrade to junk status increased more than four times in 2012 from a year ago. USD 984bn worth of credit from 52 issuers is one notch away from junk bond territory. This is largely a result of the European credit crisis, which took a toll on the banks' credit profiles. Nearly half of the potential downgrades originate from the European and American banking sectors. (Reuters)

EU tightens rules on credit rating firms

Jan 16. The European Parliament has implemented new guidelines for credit rating agencies (CRA) which will significantly affect the agencies' operations in Europe. The guidelines were created with five intentions in mind. A primary goal is to dissuade European firms from automatically adopting credit ratings. In addition, the guidelines aim to promote competition in the industry, and control the times at which CRAs can issue sovereign downgrades. In addition, the new guidelines will make it easier to press charges against a CRA for negligence and prevent CRAs from rating bonds by companies who are significant stakeholders. (WSJ)

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Contributing Editor: Dexter Tan