Weekly Credit Brief Jan 21 - Jan 27 2014

Stories of the Week

Turkey falls victim to political ambitions

By Chiranjiv Sawhney

Once perceived as an example of astounding economic success over the past decade, Turkey is now in a midst of a political crisis overshadowing its past economic gains. Trouble began on December 17 last year when the police arrested around 50 people on suspicion of corruption, implicating many members of Prime Minister Erdogan's inner circle and reportedly his own son. The response from the government included reassignment of hundreds of police officers and a prosecutor involved in the investigation. Such authoritarian behavior by the government once credited for championing the country's economic success over the past decade forms the crux of the problem.

The market impact of this political uncertainty was aplenty. Till November 2013, the aggregate 1Y RMI PD for Turkish firms had stayed under 30bps. By December end however, it rose to 36.4bps, its highest monthly reading in two years. At the time of writing, the same aggregate had reached 40bps. Turkish Lira (TRY), which had already fallen prey to the wider rout triggered by Fed tapering, shed another 16% against the USD after news of the corruption scandal emerged. The benchmark stock index lost nearly 15% in the same time period.

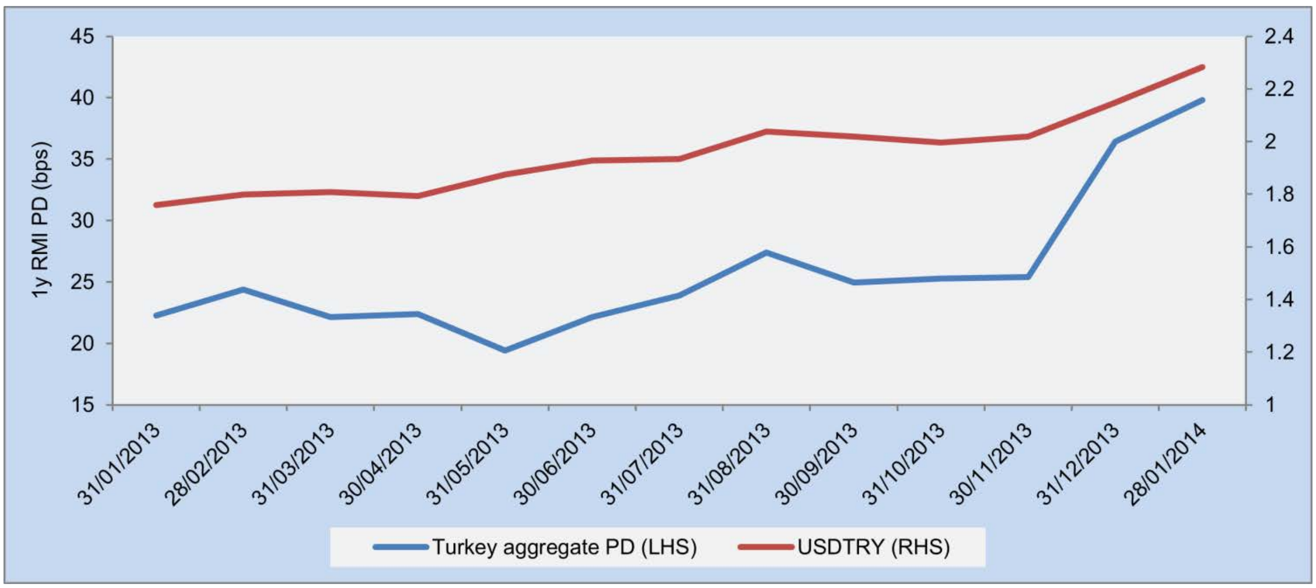

Figure A1: 1-year RMI PD for Turkey (LHS) vs USDTRY. *Source: Risk Management Institute, Bloomberg*

This increased political risk comes at a time when the economy is at a very vulnerable state. Growth has slowed and investors are worried about the current account deficit which stands at over 7% of GDP. These economic struggles have hit the Turkish bonds and CDS hard. The spread on the 5-year CDS for Republic of Turkey has risen to 275bps, more than twice the 120bps spread seen at the beginning of 2013. Yields on benchmark 10-year bonds now trade well north of 10%, despite starting 2013 around 6.5%.

Turkey, which depends to a large extent on capital inflows, cannot afford to scare investors away. To avert the latter, the central bank called for an emergency meeting for January 28 – the first extraordinary central bank meeting since August 2011. At this meeting, the central bank governor will find himself in a corner. There is intense political pressure on the central bank to keep interest rates low to spur economic growth ahead of important elections. Market participants on the other hand, call for raising interest rates to curb further declines in the TRY and to control inflation. Efforts to intervene in the Forex market have proved ineffective thus far, resulting in a loss of USD19bn - a third of the central bank's net reserves.

Taiwan announces potential banking consolidation in credit positive move
By James Weston

Last week the Taiwanese Minister for Finance, Chang Sheng-ford said the government would support mergers among local banks with the aim of creating a leading domestically-based regional bank within three years. This move would be credit positive for the Taiwanese banking sector, as a few larger consolidated banks would be more likely to win a larger chunk of regional trade flows, especially amid the ongoing internationalization of the RMB. The move may also prompt further consolidation amongst other local banks, which would help reduce competition and increase margins in the over-saturated Taiwanese financial sector.

According to RMI PD data, the credit quality of the Taiwanese banking system remains significantly better than the aggregate credit quality of banks in developed Asia (Figure B1, left); in previous publications we have said this was largely due to stable funding conditions and strong liquidity. Previous asset quality concerns have been mitigated as the non-performing loan (NPL) ratio of domestic banks fell to the lowest level in almost a year in November, while the coverage ratio (bad debt reserves to NPL) was the highest in over two years (Figure B1, right).

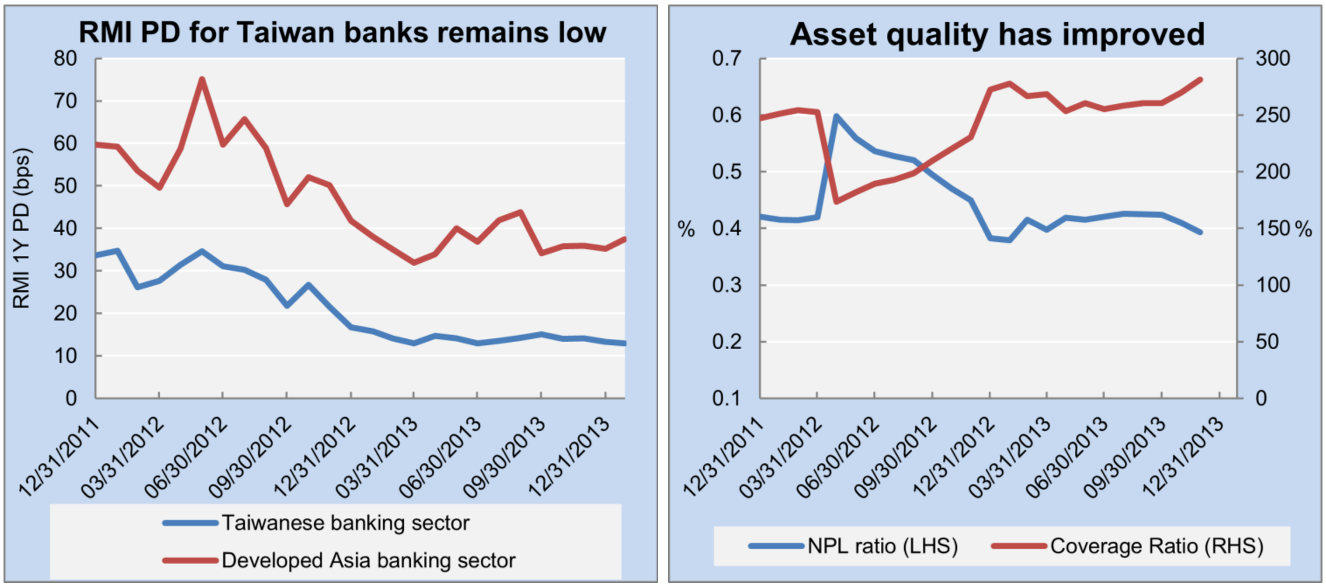

Figure B1:Aggregate RMI PD for Taiwanese banking sector and banks in developed Asia (left), NPL ratio and coverage ratio for domestic banks in Taiwan (right). *Sources: Risk Management Institute, Financial Supervisory Commission (Republic of China)*

However, weakness in the credit profiles of Taiwanese banks arises from an oversaturated domestic market which has compressed margins, and a lack of scale overseas. In particular, no Taiwanese bank currently has the same scale as large regional banks such as DBS Group Holdings, HSBC Holdings or Standard Chartered, which all have strong regional franchises. Consolidation amongst larger banks would help better position the Taiwanese banking industry as regional trade integration continues. Related to this, the continued internationalization of the RMB has created opportunities for Taiwanese banks to expand into higher margin RMB-denominated businesses due to rapidly growing RMB deposit bases.

However, such margin growth is likely to be constrained while the domestic banking sector remains widely fragmented. The five largest banks in Taiwan account for just 38% of total loans, compared with 84% for Australia and 61% in Korea. This has placed significant downwards pressure on yields on the asset side of bank balance sheets, with net interest margins amongst the lowest in the world. This competition could continue as banks compete for the smaller RMB business of smaller domestic companies, with the majority of larger Taiwanese companies already using Honk Kong as a base for RMB transactions.

The recent scandal involving uncompetitive pricing practices in the nascent domestic RMB bond market highlighted why consolidation would be beneficial for the sector. In December, the Financial Supervisory Commission (Republic of China) said it was investigating whether two state-controlled banks purposely lowered underwriting fees and coupon rates in order to win distribution rights for Formosa bonds (RMB-denominated bonds sold in Taiwan) issued by mainland banks. The episode clearly illustrated the problems a highly saturated domestic market poses to both banks and investors.

In the News

Nigerian banks face NGN 360bn new capital needs in Basel rules

Jan 27. Nigerian banks may need to increase their capital levels by up to NGN 360bn in 2014, to meet tougher international rules set by the Basel Committee on Banking Supervision. The Central Bank of Nigeria released two new circulars in December 2013 indicating that it expects banks to begin adopting elements of Basel II and III relating to market and operational risk. At the end of 2012, Nigerian banks had core capital reserves averaging about 18.1% of their risk-weighted assets. Banks with international operations are required by the Central Bank of Nigeria to meet a minimum capital adequacy ratio of 15%. (Business Day)

Argentine peso suffers steepest fall since 2002 crisis

Jan 23. Argentine Peso (ARS) saw its largest fall since 2002, falling 11% to an official rate of eight pesos to a USD. Previously, central bank support had prevented turmoil despite extremely high levels of inflation. However, the central bank paused intervention last week to contain declines in its foreign reserves coffer. The government has put in place a number of restrictions on transaction with foreign currency. Early last week, it even introduced a new restriction on online shopping. Under this restriction, anyone buying items through international websites must sign a declaration and produce it at a customs office, from where the packages can be collected. (BBC)

Eurozone debt level drops for first time in six years

Jan 22. Data released last week for the eurozone indicated that government debt across the currency bloc fell in Q3 2013 for the first quarter in nearly six years. Sovereign debt fell to EUR 8.84tn from EUR 8.88tn in Q2, with debt levels as a proportion of overall GDP falling to 92.7% from 93.4% over the same periods. While Portugal and Italy recorded drops in debt, rising levels were experienced by Greece and Spain. Although the improvement was attributed to the success of fiscal consolidation efforts and improvement in economic conditions, it was noted that sovereign debt as a proportion of overall GDP was still significantly higher than the EU's guidance limit of 60%. (Reuters)

China PBOC injects cash into banks to ease credit squeeze ahead of Lunar New Year holiday

Jan 21. In response to tightening credit conditions in China, People's Bank of China injected CNY 255bn via its open market operation on January 21 to avoid another liquidity crunch. Demand for cash typically increases ahead of the Lunar New Year holiday and injecting cash into the banking system aims to ease liquidity tensions. The PBOC also announced on its official website that it has launched a pilot standing lending facility. City commercial banks, rural cooperative banks, rural credit unions and rural commercial banks in 10 provinces and cities can tap into this facility for funds. (International Business Times)

Indian companies sell assets to ease debt

Jan 21. Indian companies are under pressure to sell their assets to raise cash, so as to fulfill their loan repayments. Many large projects, in infrastructure, have stalled due to delays in regulatory approvals stemming from tougher government policies, while rising domestic interest rates have added to borrowers' repayment woes. The non-performing rate rose to 4.2% of total loans at the end of September 2013 from 2.4% in 2009. (Wall Street Journal)

Low-rated euro zone bond yields rise after flood of supply (Reuters)

Treasury yields below Fed taper level on tepid economic reports (Bloomberg)

Rules for banks to write off bad loans relaxed (China Daily)

South Korea records fastest economic growth in 3 years (Financial Times)

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