Credit Research Initiative

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Weekly Credit Brief July 15 - July 21

Market drought puts interdealer brokers at elevated risk

Increasing bank regulations across the world are beginning to bite on brokers' revenues. With their bank clients still lingering from stiffer penalties suffered on breaches with banking regulations, interbank brokers too are suffering from falling trading volume. The declining revenues have led interdealer brokers to downsize their business. Last week, ICAP PLC, the world's biggest broker of transactions between banks announced lower annual sales in Q1 as global broking and group revenues declined by 19% and 14% YoY respectively. The industry has been hit by a slew of structural and cyclical factors such as bank deleveraging, ongoing regulatory uncertainty and the lack of volatility in the interest rate and FX markets. These factors led to a significant drag on trading activity as shown by a continued decline in the reported FICC (Fixed Income, Currencies and Commodities) revenues of major dealer banks.

The RMI 1-year probability of default (RMI PD) for ICAP has been rising over the last few months, increasing from 28bps in March to 34bps last week. This coincides with a falling market capitalization as valuations decreased from GBP 2.8bn in March to GBP 2.26bn in July. Long term debt over equity, a measure of the firm's financial leverage increased from 43% in Q1 2013 to 54% in Q1 2014, following an issuance of a 5 year EUR 350mn 7.5% senior debt in FY 2014. This had also resulted in an increase in ICAP's debt to EBITDA ratio from 1.37x to 1.92x between Q1 2013 and Q1 2014. However, ICAP outperforms its industry peers due to the relatively bigger market capitalisation.

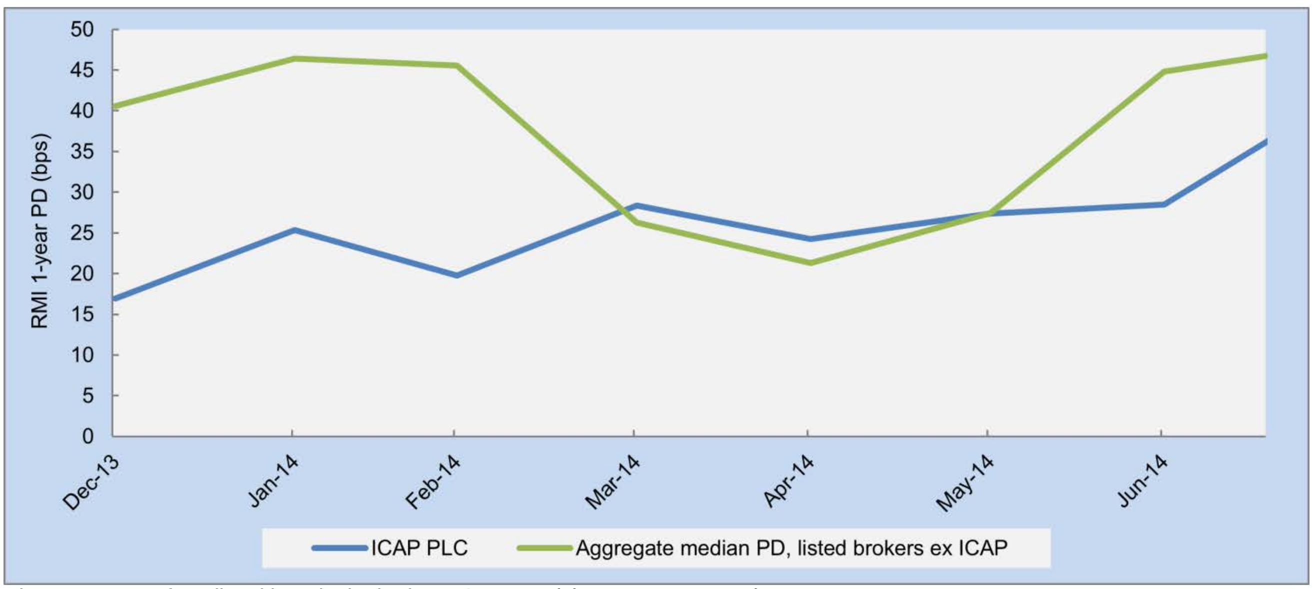

Chart 1: RMI PD for 5 listed interdealer brokers. *Source: Risk Management Institute*

ICAP CEO Michael Spencer said parts of the brokerage market is experiencing the worst volume for at least 30 years and sees no quick turnaround from the current situation. The company is therefore downsizing its so-called voice broking unit to focus on more revenue generating segments such as electronic broking and post trade services. This would also mean restructuring the business, by possibly cutting down 5% of its 2000 staffs. The cost reduction measures seem to be a necessity for ICAP as the monthly volumes of ICAP's electronic broking services (EBS) platform revealed that aggregate volumes in April, May and June this year have fallen by 4.6%, 12.4% and 14.1% YoY respectively.

The broker was slapped with USD 87mn fines from US and British authorities over its involvement in Libor interest rate rigging scandal in Q3 2013. Now, ICAP is facing an additional fine from Brussels over the past Libor scandal. The EU is also accusing ICAP of manipulating the yen Libor benchmark interest rate between 2007 and 2010.

The interdealer broker industry is witnessing sweeping reforms, as regulators push more derivatives trading onto electronic platforms to make the market more open and safer. Brokers are preparing for a new landscape post Dodd Frank this year, where customers take on less risk, use less leverage, trade more plain vanilla derivatives and rely more on technological advanced infrastructure to clear trades. Companies continue to experience challenging operating environments in the face of subdued trading activity, the more onerous regulatory backdrop and the uncertainty associated with structural regulatory reforms of the over the counter derivatives markets.

The aggregate RMI PD for listed interdealer brokers has been on the uptrend. The aggregate PD climbed from 21bps in April to 46.78bps accompanied by weaker earnings releases and higher gearing. GFI Group reported an increase of total liabilities from USD 752mn to USD 1.29bn due to higher owed amounts to brokers, dealers and clearing organizations. The firm had recorded net losses in the last 3 years due to persistently low trading volumes, which could impact GFI more than its peers due to its smaller scale and less diversified business model. While, the long running spat between BGC Group and Tullett Prebon resulted in the latter winning USD 33mn in damages from rival BGC over poaching of its key staff.

Credit News

State support for Malaysian Airlines grows

Jul 18. Market cap for Malaysian Airlines (MAS) fell as much as 18% last Friday following the crash of flight MH17 in Ukraine en route from Amsterdam to Kuala Lumpur. Market participants expect a deeper drop in future ticket sales which might eventually lead to more state support for the airliner. Khazanah Nasional Bhd, which owns 69% of MAS could delist the company as a first step towards a major restructuring exercise. Over the last 10 years, Khazanah had injected more than USD 1.6bn into the firm. (The Star)

China traders jittery over Huatong bond default warning

Jul 17. Chinese traders have become more cautious about issuing bonds after Huatong Road & Bridge Group Co. said it could default on a RMB 400mn bond which matures next week. If Huatong defaults, it would be the first private Chinese company to default both on both principal and interest payments. The default could have a more serious effect than the default of Chaori Solar Energy. The situation surrounding Huatong is a reflection of the tough operating conditions which small companies face in an economic slowdown and weak property market. (WSJ)

China rate swap jumps as bond sales pulled amid default risk

Jul 17. The cost of China’s 1-year interest rate swap soared 17bps to 4.1%, which was the biggest rise since July 22, 2013, due to concerns over a possible default in the Chinese onshore bond market. The yield on 5-year AA- rated corporate debt rose to 6.9% and the yield of 10 year sovereign bonds due June 2014 jumped to 4.45%. Analysts say that a default in the bond market would affect the yields of junk rated companies the most and possibly shake the confidence in domestic commercial paper and medium-term notes. (Bloomberg)

Fresh US sanctions hit the struggling Russian loan market

Jul 17. Some of Russia’s largest corporations - Rosneft, Novatek, Gazprombank and VEB will have difficulty refinancing their existing international loans after the US imposed new sanctions on the firms, in protest of Russia’s actions in Ukraine. The four companies have a combined USD 32.3bn of syndicated loans coming due in the next five years. Gazprombank will face the hardest hit with a USD 1.2bn loan coming due in September 2014. In early July, the US also made BNP Paribas pay nearly USD 9bn for breaking U.S. embargoes against Sudan, Cuba and Iran. At the same time, US authorities are also talking to Germany's Commerzbank and Deutsche Bank over their dealings with blacklisted countries. (Reuters)

China banks have an aggregate USD 3.2bn exposure to companies under the Qingdao fraud probe

Jul 16. With the ongoing massive fraud probe in the Chinese city of Qingdao, China's banking sector finds itself exposed to an aggregate USD 3.2bn lent to the companies covered in the probe. At the core of the fraud was the booming business of financing against warehouse receipts. Typically, the companies used commodities as collateral in order to obtain financing – issuing warehouse receipts to the lending institutions. However, it was found that many such companies were issuing receipts to mortgage multiple times which amounts to fraud. It was discovered that warehouses at ports were not as well regulated as other warehouses in the country encouraging the commodity companies to commit such frauds. Banks with exposure are taking the litigation route to secure their position. (International Business Times)

Greece seen needing third bailout as bonds insufficient (Bloomberg)

Standard Chartered, regional banks bow out (Myanmar Times)

Regulatory Updates

APRA regulator's push for big banks to set aside more capital

Jul 17. The Australian Prudential Regulation Authority has finalised the new amount of bank regulatory capital to be set aside against home loans. The existing rules allowed large banks to assign lower "risk weights" to the loans due to their more advanced internal ratings-based (IRB) systems, thus enabling them to set aside less capital for every dollar lent out. The key problem when changing the rules resided in how much does the gap need to be narrowed and what is an appropriate differential between a standardised risk weight and an IRB one. (The Sydney Morning Herald)

RBI issues draft rules for small banks in financial inclusion push

Jul 17. The Reserve Bank of India (RBI) has issued draft guidelines for firms looking to setup a payments or small bank. The intent of the new regulation is to expand the purview of banking services to more businesses and poor households. Payment Banks can accept deposits and remittances of funds but cannot provide loans. Small banks can also lend, but have more limited areas of operations than a full-fledged commercial lender. The minimum paid up capital required for both new categories of bank licenses would be INR 1bn (USD 16.62mn) of which the promoter would have to contribute at least 40% initially. Under the new guidelines, mobile phone carriers, super-market chains, co-operatives, and non-banking financial companies will be eligible to apply for permits to setup payments banks. Resident individuals with ten years of experience in banking and finance, companies and societies, non-banking finance companies and micro-finance institutions will also be eligible for setting up small banks. (Reuters)

US lawmakers want an amendment to bankruptcy rules for big bank collapses

Jul 16. Several US lawmakers are seeking an amendment to bankruptcy laws in order to deal with the next big bank failure while also avoiding any financial-market collapse. After the global financial crisis, lawmakers approved the bailout packages for Wall Street banks and also passed laws to empower regulators to wind down systemically important financial institutions. With the Financial Institution Bankruptcy Act that the lawmakers intend to bring out, bankruptcy judges will be vested with the power to privately transfer a struggling bank's assets to a new, more stable owner in less than 48 hours. Under the new bill, creditors and counterparties would not be able to cancel their contracts during the 48-hour transfer process, thereby avoiding the undue additional stress on the institution. Bailout plans, if necessary will still be used and will not be banned in the new proposed regulation. (WSJ)

Bond fee disclosures sought by SEC to end 38-year debate (Bloomberg)

Bank chief warns forex scandal could be bigger than Libor rigging (The Independent)

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Contributing Editor: Dexter Tan