NUS National University of Singapore | RMI Advancing Risk Management for Singapore and Beyond

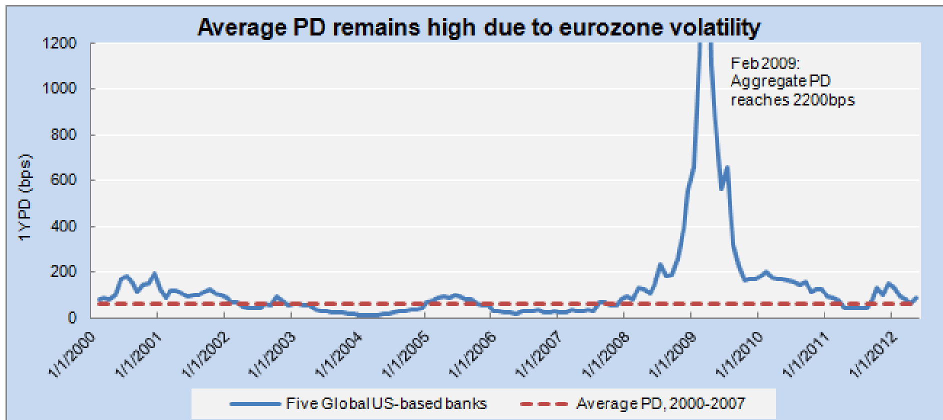
Weekly Credit Brief

Jun 19 - Jun 25 2012

Story of the Week

RMI PDs for US banks remain high as Moody's downgrades

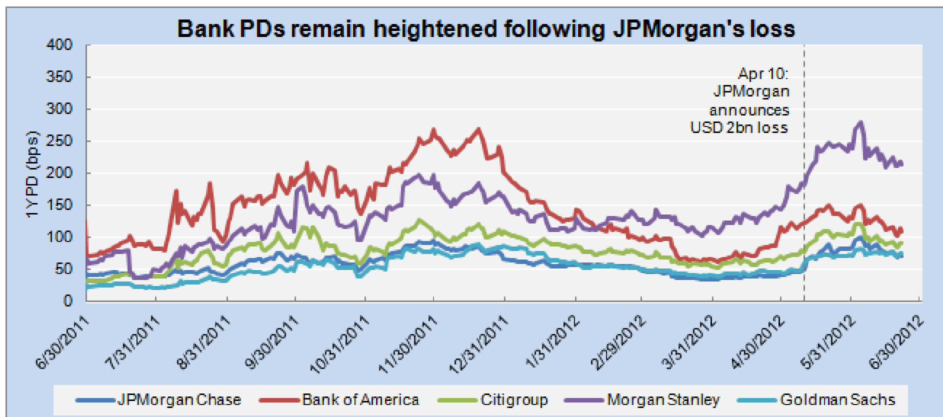
The RMI aggregate probability of default (PD) for Bank of America, Citigroup, Goldman Sachs, JPMorgan and Morgan Stanley has remained above the pre-credit crunch average over the last year, while Moody's cut the credit ratings of these five banks on June 21. The five aforementioned banks operate in a global and interconnected market, which has witnessed increasing volatility over the past five years. Since the credit crunch of 2007, revenues from capital market activities have become increasingly volatile, especially during late 2008 and early 2009. After a comparatively stable 2010, volatility in global capital markets returned in 2011, as the European sovereign debt crisis deepened.



The potential implementation of the Volcker Rule may severely curtail the revenues these five banks can draw from capital market activities. However, the rule should reduce some of the risks inherent to such activities. In addition, all five banks have dramatically improved their liquidity profiles and reduced leverage since the global financial crisis. However, concerns about company specific factors continue to weigh on each banks credit outlook, although to differing degrees.

Moody's downgrades show ratings overstated historically: The aggregate RMI 1-year PD for these five banks averaged 62.5bps between 2000 and 2007. Based on RMI calculations, a RMI 1-year PD of 62.5bps maps to a Moody's rating of Baa3 using data from the European Securities and Markets Authority's Central Ratings Repository. This is a marked contrast to an average Moody's rating of Aa3, instead of Baa3, for the 5 banks in question over the same period, suggesting ratings were historically over stated for these five banks. Following the downgrades on June 21, the average Moody's rating for the five banks fell to Baa1. RMI PDs still imply a lower average rating, as the aggregate RMI 1-year PD for the five banks remains above 62.5bps. Ratings from the other major CRAs remain significantly higher than Moody's ratings.

JPMorgan Chase: The announcement of a USD 2.3bn trading loss by JPMorgan's CEO, Jamie Dimon, during a surprise conference call on May 10 has placed upwards pressure on the bank's PD. The lack of risk oversight and problems with quantitative risk management techniques have created concern that JP Morgan has become too large to manage effectively. Recent estimates of further trading losses by market participants familiar with the underlying positions have placed JPMorgan's potential losses related to trades made by the London-based Chief Investment Office at around USD 5bn. Higher RMI PD's for all five banks reflect investors concerns about potential losses from capital market activities.

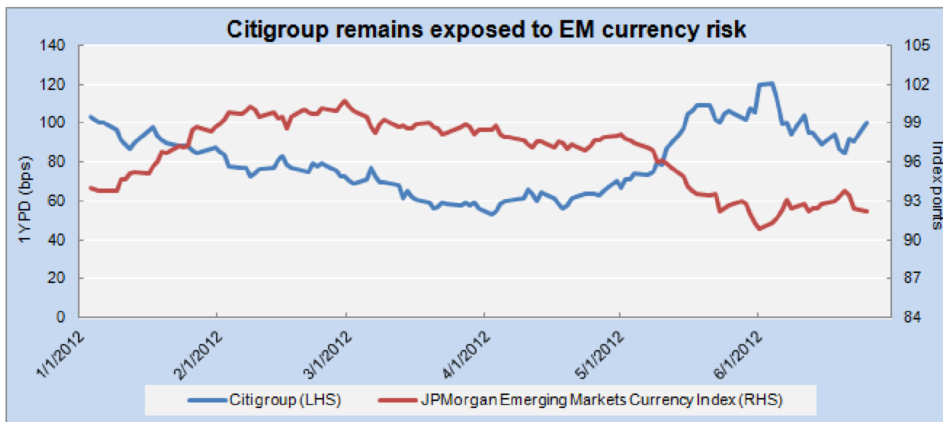


Despite this, potential further losses should have little effect on JPMorgan's earnings after Q2, with trading volumes in CDS markets during the last three weeks indicating the bank is unwinding the positions. Possible

clawbacks of employee remuneration related to the trading loss and the possible implementation of the Volcker Rule should curtail risk-taking appetite, and shift managements focus to more sustainable businesses.

However, JPMorgan remains the lowest capitalized bank in our sample group despite its size, with a Tier 1 Common capital ratio of 10.4% at the end of Q1 2012. Regardless, CEO Jamie Dimon has stated the bank is well capitalized. Mr Dimon recently told a senate enquiry the bank has no problem raising its Tier 1 Common capital ratio to 12%, but argued that diversification and sound risk management practices saw JPMorgan emerge from the GFC relatively unscathed, not higher capital levels.

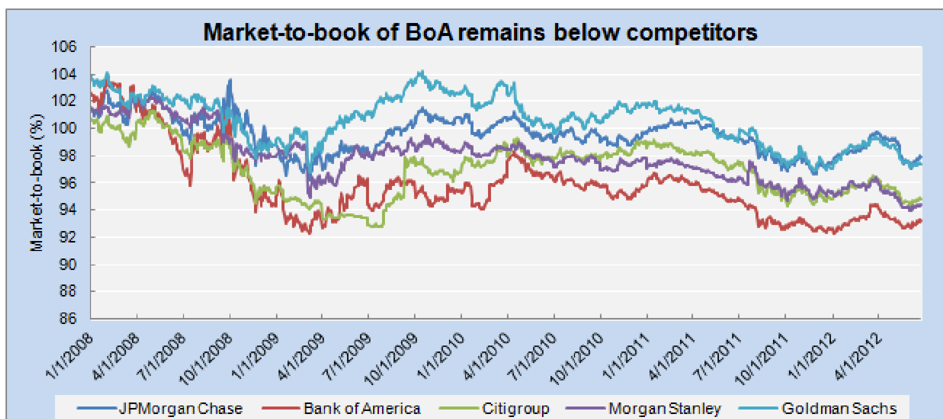
Citigroup: With a more globalized funding base and a business model that relies on emerging market growth, Citi's credit profile remains highly correlated with emerging market currencies. For example, the bank is expected to report USD 3bn to USD 5bn of foreign exchange losses this quarter, as Latin American and Asian currencies fell against the dollar during Q2 2012. Citigroup also remains bulkier than its key competitors; Citigroup has profit margin of 16.62% while market leader HSBC's profit margin is currently 27.98%.



Citigroup has disposed of over 60 subsidiaries following the subprime crisis and has reduced assets at Citi Holdings, which holds assets Citigroup considers non-core for investment and disposal purposes. However, Citi recently dismantled an oversight panel at Citi Holdings charged with overseeing the disposal of toxic or unwanted assets, despite the fact that Citi Holdings continues to hold high risk investments including Spanish and Greek bonds and overdue US mortgages. Losses at Citi Holdings continue to place downwards pressure on overall earnings: during Q1 2012 losses at Citi Holdings reached USD 1.02bn, up from USD 0.96bn in Q1 2011.

Market participants remain skeptical of Citigroup's capitalization, despite company claims it is one of the best capitalized banks in the world with a Tier 1 Common capital ratio of 12.5%. Out of the five US banks with large capital market operations, Citigroup was the only bank whose Tier 1 Common capital ratio fell below the regulatory minimum of 5% under a Federal Reserve stress test scenario completed in March 2012, assuming proposed capital distribution plans were completed. Citigroup recently announced it would halt dividend increases and build additional capital through earnings and reduction of assets at Citi Holdings. However, a simultaneous decision to redeem two issues of trust preferred shares could potentially reduce Citigroup's Tier 1 capital ratio by 50bps. Although this would have no effect on Citigroup's Tier 1 Common capital ratio, it does significantly reduce loss-absorbing capital.

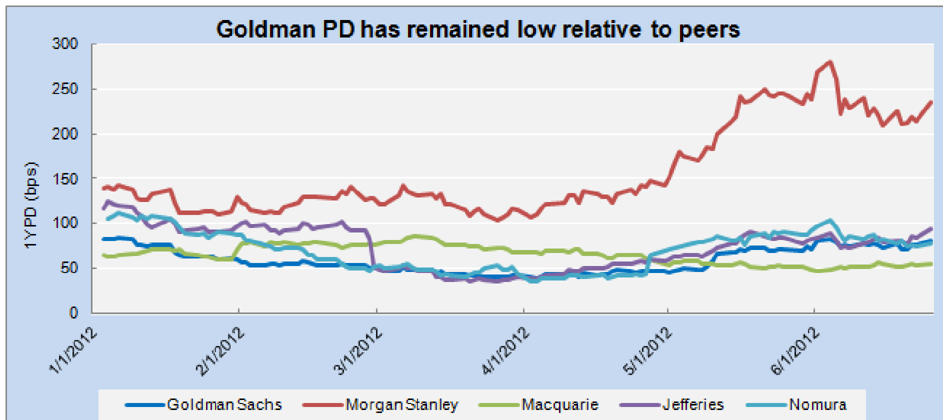
Bank of America: Despite strong support from a large domestic banking franchise and Merrill Lynch, the premier US-based wealth management group, Bank of America's (BoA) RMI PD remains above that of both JPMorgan and Citigroup, partially due to a much lower market-to-book ratio. This could indicate that market participants continue to price in the risk that BOA's legacy US residential mortgage exposures from acquisitions in 2008 and BOA's historical holdings remain a risk to the bank's financial health.



However, provisions for loan losses have fallen from USD 28.4bn in 2010 to USD 13.4bn in 2011, suggesting a marked improvement in the underlying credit quality of BoA's assets. Loan loss provisions are expected to continue to fall as BoA sheds risky assets to boost capital levels. Despite this, BoA has the second lowest regulatory capital levels out of the five banks, and concerns that current levels may not be sufficient to absorb possible loss on legacy holdings continue to weigh on BoA's share price and place upwards pressure on the bank's RMI PD.

In addition, concerns about earnings problems at BoA remain. The bank reported basic EPS of just USD 0.01 in 2011, much lower than the consensus earnings estimate. Interest costs continue to reduce earnings; the absolute size of BoA's long-term outstanding debt remains the largest of the five banks at USD 274.8bn, lowering BoA's distance to default (DTD), a volatility adjusted measure of leverage. BoA is currently planning to reduce its interest expense by USD 230mn by cutting nearly USD 40bn of its long term debt. This effort is already underway, with BoA recently announcing over USD 5bn in redemptions of long-term debt securities.

Goldman Sachs: The credit profile of Goldman Sachs remains strong versus its US-based peers, and competitors with more similarly focused business models, as observed in its RMI PD. It's positioning relative to peers reflects investor confidence in Goldman's strong risk management track record, and a major improvement in its liquidity profile. However, the bank's RMI PD has increased during the last month, as concerns about earnings volatility stemming from Goldman's strong reliance on capital market activities increased as the eurozone sovereign debt crisis continued.



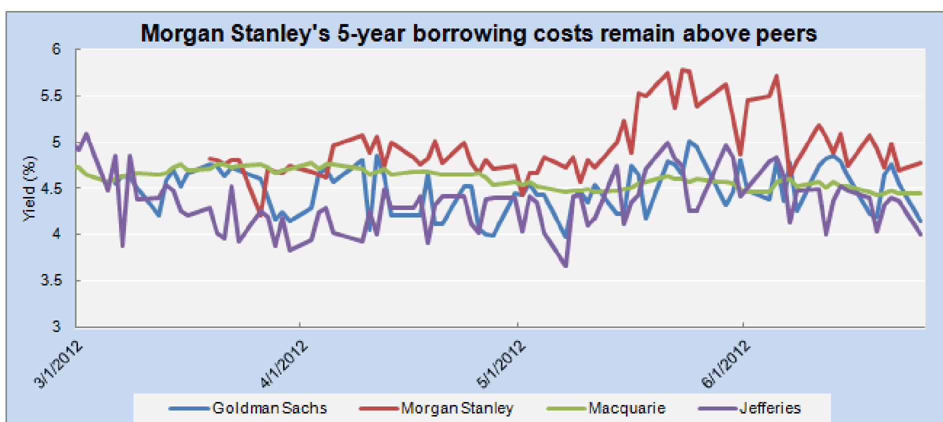
A 26.4% fall in Goldman's net revenues over during 2011 reflects these concerns. In addition, Goldman's return on equity fell to 5.33% in Q1 2012; this is significantly lower than the more diversified JPMorgan's Q1 ROE of 9.84%. The implementation of the Volcker Rule may constrain Goldman's ability to generate revenues from many current trading activities.

Absolute exposures to peripheral eurozone countries also remain a major concern. At the end of 2011, Goldman disclosed gross exposures to GIIPS nations of USD 3.9bn, a majority of which is Italian debt. However, this exposure is relatively small compared to loss-absorbing capital, with Goldman having the second highest regulatory capital levels in our sample group, with a Tier 1 Common capital ratio of 12.9%

Morgan Stanley: Despite Morgan Stanley having the highest regulatory capital ratios in its peer group, with a Tier 1 Common capital ratio of 13.3%, it currently has the highest RMI PD amongst its peers. This could stem from two factors that weigh on the bank's credit profile: increased collateral and payments demands following Moody's two notch downgrade of the bank to Baa1 on June 21, and concerns about federal investigations following the bungled Facebook IPO.

In a securities filing on May 7, Morgan Stanley estimated it may have to post USD 7.2bn worth of additional collateral and termination payments if Moody's downgraded the bank a full three notches to Baa2, instead of the realized downgrade to Baa1. Although Citigroup and Bank of America were each downgraded a notch lower to Baa2 on June 21, Morgan Stanley lacks a similar core deposit base, and has a higher dependence on fixed income businesses sensitive to counterparty credit quality. This could reduce revenues from these business and long-dated derivatives.

Related to this, Morgan Stanley continues to face borrowing costs higher than its major competitor Goldman Sachs and banks with similar business models. Markets appear to have priced in a higher borrowing costs for Morgan Stanley even before the bank was downgraded; smaller competitors currently enjoy a relatively lower 5-year borrowing costs.



Furthermore, Morgan Stanley recently increased its stake in Morgan Stanley Smith Barney, its retail brokerage joint venture with Citigroup, from 51% to 65% on June 1. Morgan Stanley has the option to purchase the remaining shares over the next 2 years. However, investors remain cautious of this investment, as the cash needed to fund the purchase will further weigh on Morgan Stanley's earnings. Unexpected losses from a similar brokerage joint venture with Mitsubishi UFJ last year during tough market conditions have created concern that

increased ownership of Morgan Stanley Smith Barney could reduce future earnings.

Sources:
BlueMountain said to help unwind JPMorgan's whale trades (Bloomberg)
Citigroup faces USD 5bn hit on dollar's rise (Bloomberg)
BoA to repurchase USD 3.9bn of its trust securities (Bloomberg)

In the News

Moody's downgrades 15 banks with global capital market presence
Jun 21. Moody's downgraded 15 global banks with significant capital markets operations, following a reassessment by Moody's of the risks and volatility inherent in investment banking and principle taking activities. Including the five US banks mentioned above, Moody's downgraded 10 other global banks. Switzerland-based Credit Suisse received the largest downgrade, down three notches to A2 from Aa2; compatriot UBS was downgraded two notches to A2 from Aa3. France-based Crédit Agricole, BNP Paribas and Société Générale, Germany-based Deutsche Bank and UK-based Barclays were each downgraded by one or two notches to A2. RBS was downgraded one notch to A3. HSBC and the Royal Bank of Canada remain the highest Moody's rated banks with significant capital operations with Aa3 ratings, although HSBC remains on negative outlook. (Moody's)

Fed expands Operation Twist by USD 267bn through 2012
Jun 21. The US Federal Reserve will continue its Operation Twist program till the end of the year, in an effort to improve a stubbornly high unemployment rate which remains above 8%. Under the program, the Fed buys longer-term debt securities and sells shorter-term debt, placing downwards pressure on longer-term interest rates and encouraging corporate America to step up investments and hiring. The Fed plans on expanding the level of debt purchases and respective sales by USD 267bn till the end of 2012, with the original USD 400bn program announced in September 2011 expiring at the end of June. The Fed last year committed to maintain current "exceptionally low" interest rate levels through 2014, implying the Federal Funds Target Rate will remain between zero and 0.25% for the next year and a half. (Bloomberg)

China steps said to grow bond market, add issuer scrutiny
Jun 20. Chinese regulators began taking steps to ensure expansion of a nascent domestic bond market is not derailed by defaults last week. The National Development and Reform Commission (NDRC) ordered local officials to monitor the ability of local government backed companies to repay debt maturing before 2014. The NDRC will restrict the ability of such companies to issue bonds in the future. Debt issued by Chinese companies in the first five months of 2012 has already outpaced the total issuance in 2010, as the government attempts to reduce reliance on loans from state-owned banks. The China Securities Regulatory Commission (CSRC) has recently allowed mutual fund to buy bonds issued by smaller companies, although stringent disclosure rules and investment limits apply. Moreover, during the last two years China has gradually allowed the trading of junk bonds, municipal debt and credit default swaps (CDS). Chinese financial regulators may introduce a market for government bond futures in the near future. (Bloomberg)

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