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Weekly Credit Brief Jun 21 - Jun 27

Trying times ahead for UK financial services and real estate after Brexit vote

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The UK began a new chapter in history on 23 June 2016, as the nation voted to leave the European Union (EU), an action commonly referred to as the Brexit, after a marriage spanning more than 40 years. The decision is anticipated to come with wide-ranging impacts, from the prospect of London losing its position as a top financial center to, possibly, a prolonged slowdown for the global economy that has yet to emerge fully out of the Great Financial Crisis of 2008. As votes being tallied after the referendum began to point towards a Brexit, investors scrambled to price in the new reality into their portfolios, sending markets trading lower globally. Beyond the initial reactionary response from investors, the UK economy is slated for major structural changes in the coming few years.

Investment bank Goldman Sachs has earmarked the banking and the real estate sectors to be affected the most by the decision to leave, on the assumption that the economic engine of the UK would contract in the ensuing years. Analysts at the bank found that there is a correlation of 0.56 between the annual earnings growth of banks and the domestic demand in the country since 1998, while the same measure for real estate investment companies and home builders are 0.55 and 0.53, respectively. At the other end of the spectrum, the industrial metals and media sectors are both negatively correlated to the local demand.

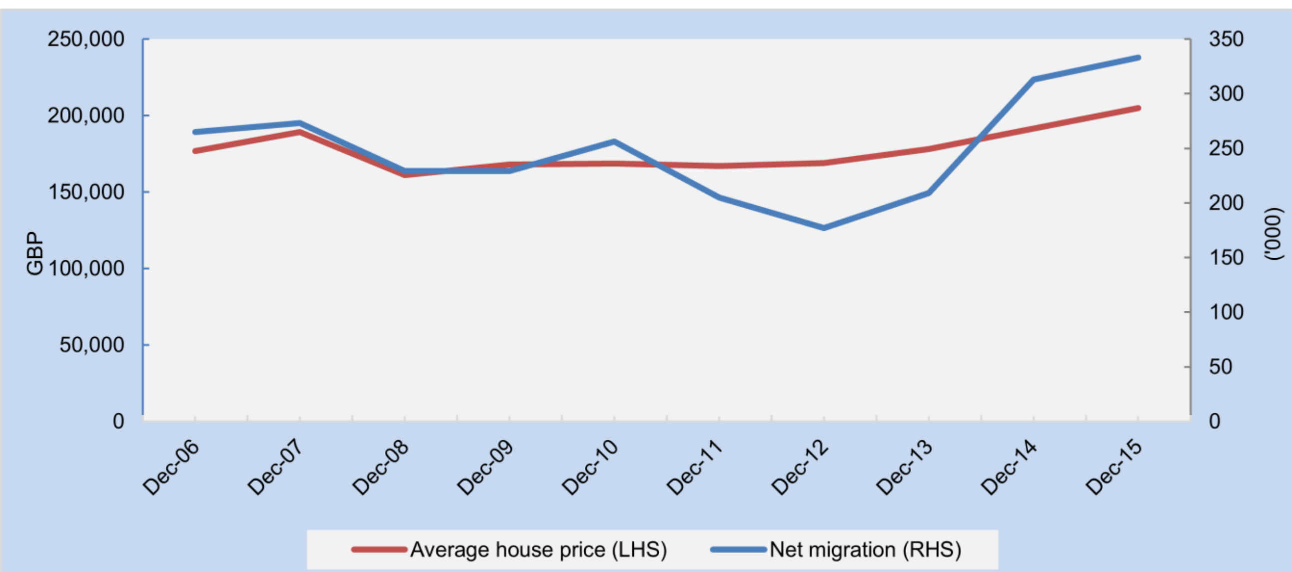

Figure 1: The average price of a house and net migration in the UK. *Source: Office of National Statistics*

Indeed, international migration has been a significant driver of growth in the UK real estate sector for the past decade (see Figure 1). Based on the data published by the Office of National Statistics, the average price of a house in the UK expanded by 4.5% annually between 2006 and 2015. Concurrently, the UK population increased by an average of 500 thousand people annually, of which net migration contributed about half. In London, where about a quarter of its population were foreigners in 2014, the pace of growth is far more evident. During the ten-year period, housing prices have surged by more than 70% on average. With the Brexit decision, which is likely to stem the inflow of immigrants, the real estate sector may lose a key pillar of growth.

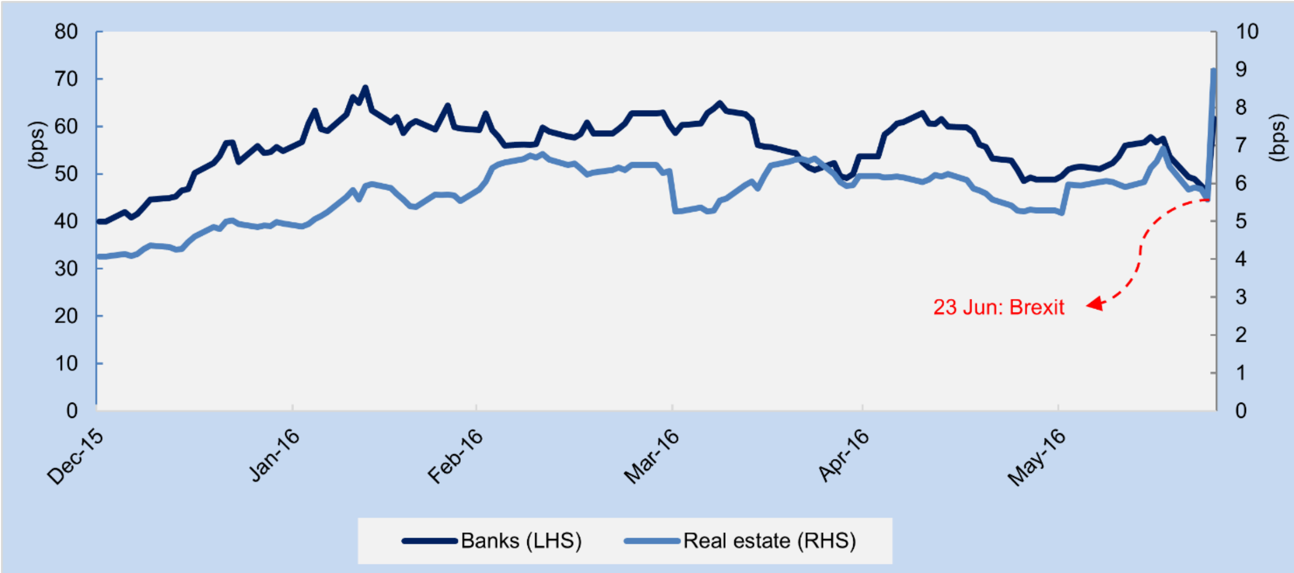

Figure 2: The RMI-CRI 1-year PD of the UK banking sector and the aggregate RMI-CRI 1-year PD for 25 large-cap real estate businesses in the UK. *Source: RMI-CRI*

In the months leading to the referendum, the RMI-CRI 1-year Probability of Default (PD) of the banking and the real estate sectors have also climbed higher (see Figure 2). The average PD of the UK banking sector increased to 47.5bps as of 22 June 2016, from 40bps at the beginning of the year. Similarly, the average PD for the real estate group – comprising 25 real estate operators, managers and developers, as well as the real estate investment trusts (REIT) with market capitalization of GBP 1bn and above, climbed from 4bps to 5.8bps. While the outcome of the referendum is not legally binding, the uncertainties that it has already created would keep the market capitalization of the companies in these sectors depressed in the near term. In the aftermath of the vote, the banking sector lost almost 12% of its market value while the real estate sector lost nearly 19%. The degradation of the capital structure of these companies will weigh on their PDs given that there is less room for maneuverability in the credit markets.

Certain businesses with high levels of debt may find themselves running into tight credit situations in the current market. For instance, Intu Properties, a REIT valued at more than GBP 4bn prior to the referendum, had a total debt to total asset ratio of 0.44 and an EBITDA to interest expense ratio of 3.03 as of the end of 2015. The company may now have to pay more to keep its existing capital structure, as the zero-coupon spread on its asset-backed bond maturing 2024 surged by 18bps to 187bps, the day after the referendum. With over GBP 500mn in term loans and bonds maturing through 2018, the costlier refinancing of its debts would further squeeze the narrow cushion of earnings that it has over its interest expense and, thus, maintain upward pressure on its PD.

For the British banks, the big question mark centers on banking passports, which grant them the right to market financial services in the EU. Depending on how the exit is executed, the British banks may have to apply for new licenses to continue serving the continental markets. On this point, Brexit could not have happened at a more inopportune time. In recent years, major British banks such as Barclays and the Royal Bank of Scotland have cut back on their global operations. Further constriction to the revenue stream from reduced access to the EU markets will deal a heavy blow to their earnings, which are already feeble from ongoing legal settlements and restructuring expenses. Given the dim earning prospects, the PD for this sector is also anticipated to remain elevated for the foreseeable future.

Leaving the EU is set to be a drawn-out process. In his speech outside 10 Downing Street, the morning after the Brexit vote, outgoing Prime Minister David Cameron had outlined a period of three months for his successor to be appointed, to lead the work on taking the country out of the EU. Thereafter, months of negotiations with the EU leaders would follow, on all aspects of the UK-EU relationship to keep disruptions to daily affairs as low as possible. Until then, businesses continue to be shrouded in uncertainties.

Credit News

Insurers face heavy debt defaults from risky assets

Jun 27. The top five China insurers had opted for risky investment products in order to offer higher return to their customers. These alternative investments - including opaque, risky shadow banking-linked assets (e.g. trust schemes and wealth management products) - contributed 16% of the top five's total assets and had more than quadrupled since 2011 to USD 150bn. These risky investment products were illiquid as it lacked a secondary market and had a long investment horizon. They were channeled to debt-laden firms with increasing risk of default when banks' non-preforming loan already reached its 11-year-high of almost 2%. With China economy slowdown, this could potentially trigger heavy debt defaults and insurers' balance sheets crisis. (Shanghai Daily)

IMF calls for audit of Mozambique's undisclosed debt

Jun 24. The IMF suspended lending to Mozambique after a secret loan were undisclosed in April by The Wall Street Journal (WSJ). The IMF emphasized the need for an "international and independent audit" of the debts. Mozambique's debt problem began in 2013 and 2014 when its former government guaranteed USD 1.2bn of loans and USD 850mn of bonds for the state-owned companies. WSJ claimed that the loans were used for military-purposes instead of paying for the tuna-fishing vessels. Mozambique swapped the "tuna bonds" into sovereign debt in April. One of the state-owned companies missed a USD 178mn loan payment in May and was negotiating a restructuring with VTB. (WSJ)

Solocal starts USD 1.3bn debt overhaul under French court

Jun 23. Solocal Group began a court-backed process to restructure EUR 1.1bn of debt, its second reorganization in about two years. The French directories publisher called for the Commercial Court of Nanterre to appoint a restructuring adviser, triggering a default event on EUR 350mn of June 2018 bonds. Solocal warned it is unable to fulfill debt obligation in 2018 as online services lure users from the traditional print directories. The publisher, which reorganized EUR 1.6bn of borrowings in 2014 also struggled to invest in digital products due to its debt pile. Solocal said it risks breaching loan covenants as soon as the end of June. It plans to ask holders of bonds issued by a financing vehicle to become direct creditors so they can take part in restructuring talks. (Bloomberg)

Belgium's VLM Airlines files for bankruptcy

Jun 22. Belgian regional VLM Airlines has confirmed that it has filed for bankruptcy, cancelling all flights with immediate effect. The carrier had filed a formal application in May asking for creditor protection for six months to avoid bankruptcy. Unfortunately, the company does not have the capability to fulfill its financial obligations in this six months. Additionally, a planned sale-leaseback deal for several aircraft in its fleet had failed because VLM would have needed at least two or three additional months for a successful recapitalization, further worsening its financial woes. (ATW)

Eurozone PMI at lowest level since 2014 (FT)

BRICS eye a new rating company to reduce established firms' grip (Bloomberg)

Ratings agency Moody's says Britain at risk of credit downgrade (CNA)

Regulatory updates

Bank-sovereign doom loop requires fiscal response

Jun 26. The Bank for International Settlements (BIS), stated that tougher actions from policy makers are required to break the link between banks and sovereigns that spread chaos during the last financial crisis. According to the BIS, regulations of government debt on banks' balance sheets is "no longer tenable". While Chairman of the Basel Committee Stefan Ingves mentions that policy makers would have to carefully review options to tighten capital rules around the bank's holdings of sovereign debt, the BIS states that more measures need to be undertaken to resolve this issues. For instance, treasuries worldwide have to amend their fiscal policies to prevent bubbles, free up space for intervention when necessary and to remove incentives that weaken the financial system. (Bloomberg)

China bankruptcies surge as government targets zombie enterprises

Jun 23. Within the first quarter of 2016, courts in China accepted 1,028 bankruptcy cases – a marked increase as the government exercises the use of bankruptcy laws to cut back on industrial overcapacity in a wider attempt at restructuring the economy. According to the director of the bankruptcy research centre at Renmin University law school Wang Xinxin, for many years, local courts were unwilling to accept bankruptcy cases or local governments prevented the use of bankruptcy laws due to other possible social impact such as unemployment. At present, concerns have emerged regarding the bankruptcy laws allowing some zombie companies to continue operating through mergers or restructuring rather than liquidation. However, experts point out that liquidation-style bankruptcies outnumber restructurings. (FT)

Fed stress tests: all big banks clear bar for capital requirements

Jun 23. The Fed announced on Thursday that the largest US banks are well-prepared to face severe downturn and to continue lending during a deep recession. The 33 largest banks in the U.S. cleared the Fed's stress tests as the banks reported steady increase in bank capitals, improvement in loan quality, and a drop in the crisis-era litigation cost. The Fed will soon release the second part of test which will reveal the regulator's decision to either allow or block banks to return their capital to the shareholders. The stress tests are just one of the new regulations that a bank must adhere to. The goal is to ensure the bank's ability to lend during a bad economic condition and to minimize the risk of a bank failure. (WSJ)

U.S. regulators keep eye out for risks from marketplace lending (Reuters)

China defends banks' strategy on managing debt pile (FT)

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