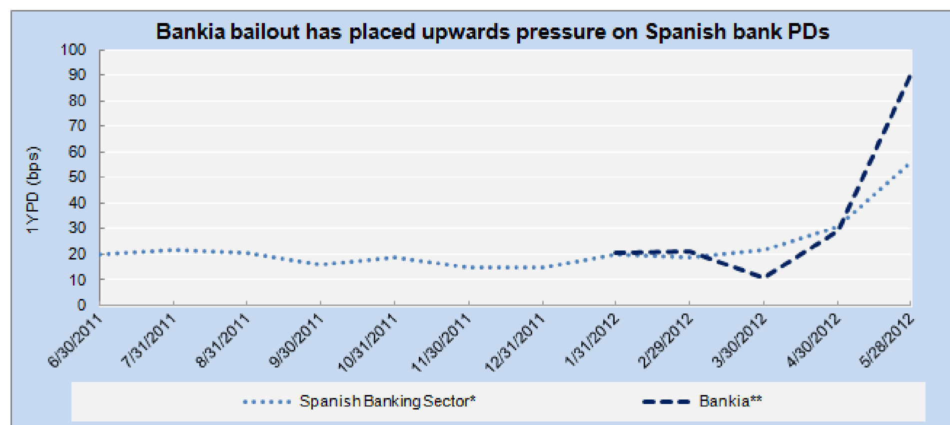
Story of the Week

Bankia rescue weighs on credit outlook of Spanish banks

A large increase in the size of Bankia's bailout last week has caused a deterioration in the credit outlook for the Spanish banking sector. The 1-year aggregate probability of default (PD) for the Spanish banking sector increased to 56bps on May 28 from 31bps on April 30, while Bankia's PD increased to 89bps on May 28 from 29.2bps on April 30. Bankia's recapitalization increased concerns about the liquidity profile and real estate exposure of Spanish banks. In addition, as the recapitalization could be in the form of Spanish government debt, the bailout will further increase linkages between the Spanish sovereign and the banking sector, and could impair the government's ability to support other lenders. Concerns remain about the degree of exposure to troubled real estate assets at Spanish banks, following large changes in provisioning requirements since February. Nascent plans to establish "bad bank" entities to remove toxic assets from the balance sheets of Spanish banks may alleviate these concerns somewhat.



Recapitalization of Bankia: Troubled Spanish bank Bankia, the third largest Spanish bank by assets which was formed through the merger of seven regional savings banks in 2010,, sought EUR 19bn from the Spanish bank bailout fund FROB on May 25, after the lender's parent was nationalized on May 9. The same day, the bank revised its 2011 earnings from a EUR 300mn profit to a EUR 3bn loss, due to increased loan impairments. Bankia has the second largest deposit base in Spain and residential loans to individual customers comprise 61.4% of the bank's loan book. The Spanish government could issue government or FROB debt directly to Bankia instead of cash in the recapitalization, allowing the bank to use the debt as collateral to borrow directly from the ECB. The size of the bailout will drastically reduce the ability of the Spanish government to help other Spanish banks, while concerns about the sector's viability could make it difficult for the government to complete a planned sell-off of three other nationalized lenders in July.

Sovereign bond holdings: Issuing recapitalization funds in the form of government debt would drastically increase Bankia's exposure to increasingly adverse market conditions: the yield on 10 year Spanish bonds reached 6.48% on May 28. Moreover, after two rounds of cheap funding through the ECB's LTROs, Spanish banks increased their overall holdings of general government debt by EUR 85bn to EUR 263.3bn between December and April in so-called carry trades. Increasing concerns about the health of the Spanish banking sector, and a potential Greek exit from the eurozone could drive yields on Spanish government debt even higher and prompt deposit flight, further impairing the balance sheets of Spanish banks.

Deposit flight and liquidity: Last week, Spanish newspaper El Mundo reported that depositors had withdrawn approximately EUR 1bn from Bankia since May 9, Furthermore, the minimum cost of bailing out Bankia for the Spanish government increased from EUR 9bn on May 23 to EUR 19bn on May 25, suggesting Bankia's liquidity profile is rapidly deteriorating due to a silent bank run. This weighs upon the credit outlook for the rest of the Spanish banking industry, with Spanish depositors increasingly concerned about the sector following Bankia's bailout. In addition, Spanish banks are becoming increasingly dependent on ECB funds for liquidity. Spanish lenders are believed to have received around 30% of total LTRO funds offered in the December and February operations. Net borrowing by Spanish banks from the ECB climbed to EUR 263.5bn in April, after doubling in between January and March. According to RMI PD data, Banco Espanol de Credito and Banco Popular Espanol have exhibited similar PD behavior to Bankia in the past fortnight, indicating they may be the next lenders in need of support from the Spanish government.

Real estate exposures: According to the Spanish government, Spanish banks have EUR 184bn worth of real estate loans that are considered problematic. Bankia's EUR 3bn increase in loan impairments for 2011 have raised concerns that impairments at other lenders may have been understated. In addition, Spanish banks are said to be masking their full exposures to property developers by refinancing existing loans, as Spanish banks are allowed to consider loans refinanced before delinquency as normal or performing. Reflecting increased government fears regarding the former, Spanish banks were forced to set aside additional provisions of EUR 30bn on performing loans last week, on top of the EUR 54bn in provisions and new capital requested by the government in February, impairing the sector's profitability for the foreseeable future.

Establishment of “bad bank” entities: The Spanish government is considering various forms of “bad bank” structures, in order to cleanse Spanish banks of toxic real estate assets once and for all, a credit positive for the sector. The most prominent plan involves banks transferring soured assets to real estate holding entities that would independently value and sell-off assets. Banks would have a stake in the companies; while the Spanish government would offer financial support to encourage investor participation.

*Banco de Valencia was excluded from the aggregate PD for the Spanish banking sector due to a rights issuance, and Banca Civica was excluded due to incorrect financial statement data.

**Bankia’s PD is only available from January 1, as the company was listed in July 2011.

Sources:
Spain’s borrowing costs rise as bank woes deepen (New York Times)
Spain may use its debt instead of cash for Bankia group (San Francisco Chronicle)
Spain imposes EUR 30bn of provisions on banks (Bloomberg)
Spain delays and prays that zombies repay debt (Bloomberg)

In the News

Greek banks obtain EUR 18bn for recapitalization
May 22. The four largest Greek banks will receive EUR 18bn for recapitalization after receiving approval from the Hellenic Financial Stability Fund (HFSF) for release of funds last week. The banks will receive the funds in the form of European Financial Stability Fund (EFSF) notes, allowing the four banks to once again participate in the ECB's liquidity operations. The ECB halted funding operations with some Greek banks a fortnight ago, over concerns that a number of Greek banks lacked the capital to be considered solvent. (Reuters)

EM bond defaults: rising
May 22. Emerging market (EM) bond issuance has reached a record high of USD 403.2bn in the first five months of 2012. However, there was USD 6bn of EM bond defaults during the first four months of this year alone. Market participants have cautioned investors to exercise due diligence before investing in EM bonds, as the default rate in EM bond markets may reach 3.25% this year. Over USD 73bn of EM corporate bonds are trading at distressed levels, while USD 53bn of issuance is trading at stressed levels. A liquidity crisis caused by a resurgent eurozone debt crisis may push the EM corporate default rate to 12.9%. (FT)

Ford regains its credit rating and famous logo
May 23. Moody’s upgraded the credit rating of Ford two notches to Baa3 last week, the lowest investment grade rating, from Ba2. The upgrade allows Ford to reclaim its famous blue logo, which the company had pledged as collateral along with other assets to avoid bankruptcy in 2006. Moody’s believes restructuring at Ford’s North American operations would allow the company to maintain production at profitable levels. The company was upgraded to BBB- by Fitch in April; S&P is the only rating agency currently maintaining a non-investment grade on the company. (The Independent, Bloomberg)

Germany won’t bend on Euro Bonds, Deputy Minister Steffen says
May 24. Two-year German bond yields fell as low as 0.02% on May 23 amid speculation that Greece could exit the eurozone. Germany auctioned two-year notes with a zero percent coupon the same day, with the auction attracting 1.7 times the issuance sold. These factors suggest the yield on German bonds could turn negative as a second round of Greek elections on June 17 approaches, as investors seek safety and capital preservation. However, a number of institutional investors have cut exposures to German bonds, on concerns the market is overvalued, and longer-term concerns about Germany’s financial health, given the large amount of public money Germany may have to spend to keep the eurozone together. (Reuters, WSJ)

Published weekly by Risk Management Institute, NUS | Disclaimer
Contact the editor at weeklycreditbrief@nus.edu.sg