Weekly Credit Brief Oct 6 - Oct 12 2020

US banks remain relatively well-endowed to weather credit risks ahead

by Lee Wei Qi

- **The well capitalised US banking industry signals greater caution moving forward**
- **NUS-CRI Agg and Forward PDs reinforce positive credit sentiments towards the US banking sector**

Macroeconomic woes and uncertainties continue to loom over the US economy due to the Covid-19 pandemic and the impending US elections. In spite of prevailing volatility, the US government and the Federal Reserve (Fed) have been formidable backstops to struggling individuals and corporations. While the NUS-CRI's Aug 2020 brief highlighted the deteriorating credit outlook for US domiciled corporates, this issue will focus on the US banks' credit profile and outlook as they remain critical conduits for effective monetary transmission.

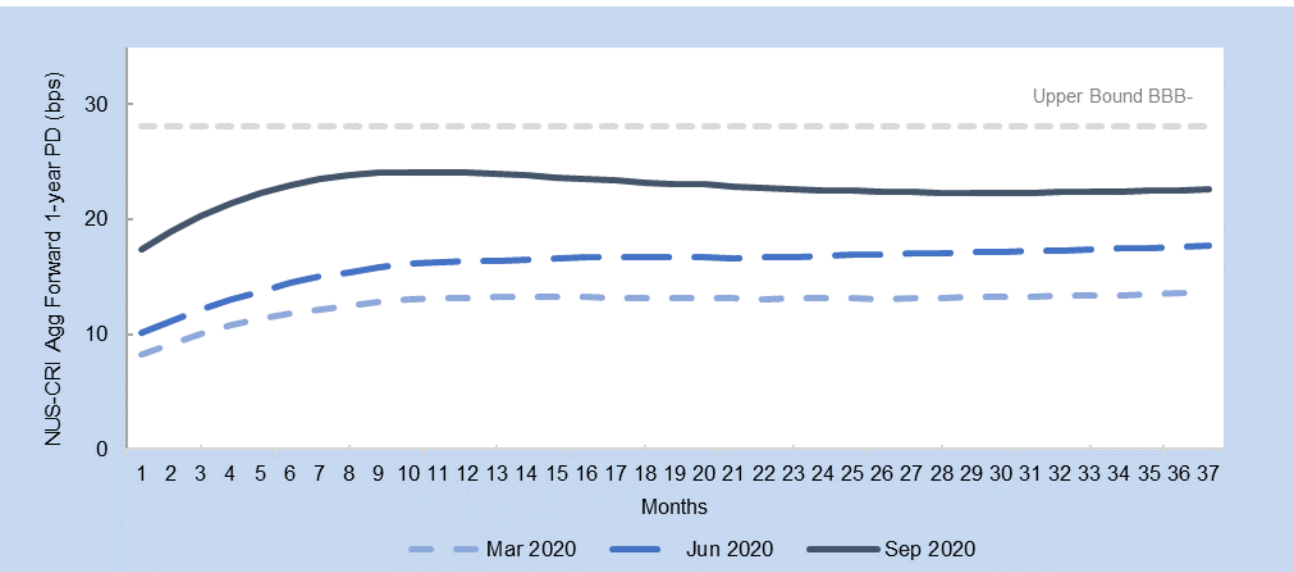

Figure 1: NUS-CRI Agg Forward 1-Year PD of US domiciled banks based on data feed as of Mar 2020, Jun 2020, and Sep 2020 with reference to the PDiR2.0[1] *Source: NUS-CRI*

The deteriorating economic conditions in the US have resulted in a subdued credit forecast for US banks. This is corroborated by the NUS-CRI Aggregate (Median) Forward 1-year Probability of Default (Forward PD[2]) in Figure 1 where the trend lines as of Mar 2020, Jun 2020, and Sep 2020 illustrate increasingly elevated term structures on a quarterly basis. The existing macroeconomic environment have strained asset quality and profitability, resulting in an increasingly dim credit outlook for the US banking industry.

With falling income and rising unemployment, individuals and corporates are increasingly unable to meet their debt obligations, thus leading to an increase in non-performing loans (NPL) from 0.85% (Q4 2019) to 1% (Q2

[1] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation through mapping the NUS-CRI 1-year PDs to the S&P letter grades. The method targets S&P's historical credit rating migration experience exhibited by its global corporate rating pool instead of relying solely on the reported default rates.

[2] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similarly to a forward interest rate. For example, the 6-month Forward 1-year PD is the probability that the firm defaults during the period from 6 months onwards to 1 year plus 6 months, conditional on the firm's survival in the next 6 months.

2020). A relatively modest 15bps would have been much higher without a strong government support benefitting the pandemic-hit borrowers. These include the Paycheck Protection Programme, the Main Street Lending Programme, and the hefty stimulus check. When loans forbearance and fiscal support cease, the US banks are expected to face a substantial loan loss of USD 427bn over the next 3 years. In response to worsening credit conditions and rising NPLs, there has been a robust uptick in loan loss reserves. Since the start of the pandemic, the US domiciled lenders have increased their provisions by USD 110bn. The current level stands at 2.19% of their existing loan portfolios, an all-time high from 2012. The high level of provisions set aside could attest to the US banks' expectations of the credit environment moving forward. While this is a necessary step, increasing provisions often comes at the cost of profitability.

After reducing the rates by 150 bps in Mar 2020, the central bank has announced the plan to keep interest rates within a 0-0.25% range until 2023. The dovish monetary stance has resulted in a flattened yield curve. Correspondingly, the US banking industry's aggregate net interest margin has fallen from 3.31% (Q4 2019) to 2.89% (Q2 2020). In light of the profit challenges ahead, it is critical for the banks to carefully tread the line between risk management and credit extension.

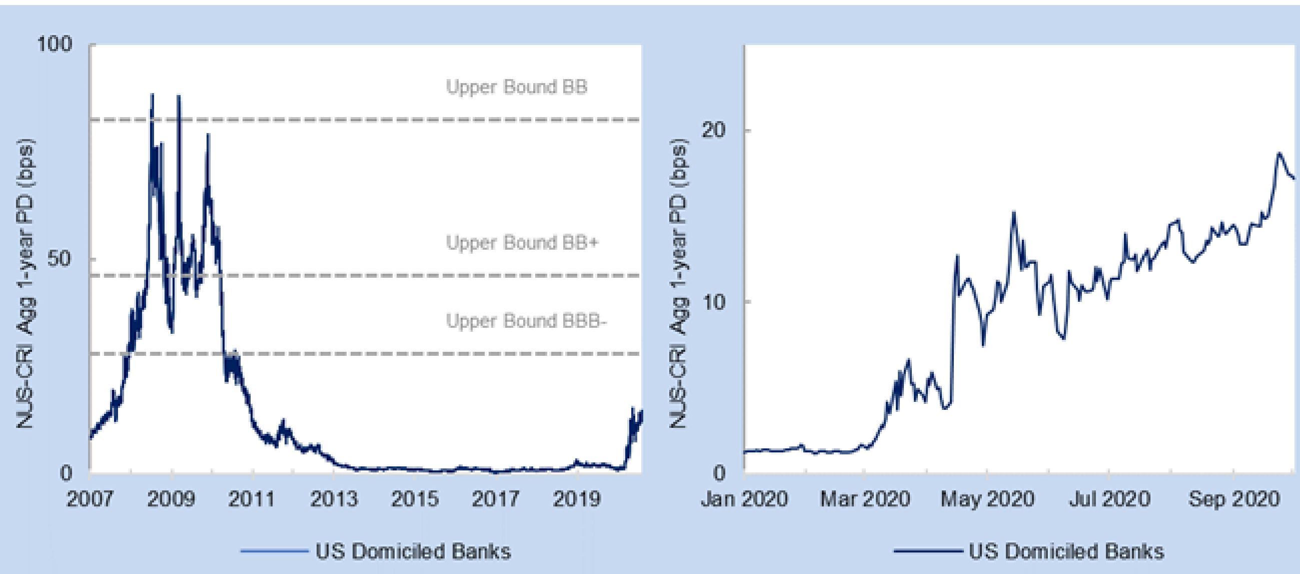

Figure 2a (LHS): NUS-CRI Aggregate 1-year PD of US domiciled banks from Jan 2007 to Oct 2020 with reference to the PDiR2.0 bounds
Figure 2b (RHS): NUS-CRI Aggregate 1-year PD of US domiciled banks from Jan 2020 to Oct 2020 *Source: NUS-CRI*

The US banks held up relatively well against the Covid-19 outbreak when contrasted with the surge in NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) during the Great Financial Crisis (GFC). As evident in Figure 2a, the Agg PD of the US banking sector saw a spike of 67.5bps during the GFC. Conversely, today, the Agg PD in Figure 2b saw a mere YTD increase of 17.4bps. Notably, the 2020 Agg PD and Forward PD of the US banking industry kept within the investment-grade threshold proxied by the NUS-CRI Probability of Default implied Rating 2.0.

These observations reflect the strong capital position of the US banking sector. Entering 2007, the aggregate Common Equity Tier 1 Capital Ratio (CET1) of US domiciled banks stood at 7%. This ratio dwindled to 5% by 2010. Entering 2020, the aggregate CET1 ratio of US banks hovered around 12%. As the Covid-19 pandemic progress, Mckinsey projected that it could decline to 8% in the worst case scenario – a level above the 2007 CET1 ratio of 7%. In addition, the US banks have taken precautions against the impending rise of criticised loans. The sector's loan loss reserve to total loans ratio rose from 1.18% (Q4 2019) to 2.19% (Q2 2020). The Fed has also curbed dividends and shares buybacks for the rest of 2020 to ensure that the US banks maintain a degree of capital resilience.

All in all, there remain some silver linings for the US banks moving forward. The Fed has provided great liquidity in a support of the US economy. With yet another stimulus in the works, the demand for loans have dipped. In addition, the low interest rate environment and the Fed's purchase of corporate debts have allowed the US banks to enjoy rising profit from trading and debt sales. Nevertheless, attention remains on the efficacy of the

US economic and public health policies as these factors would determine the course of recovery and, correspondingly, the credit profile and outlook of the US banking industry.

Credit News
Japan bank lending slows as easing pandemic sees big firms pay back loans **Oct 12**. Japan's bank lending increased at a slower annual pace in September compared to previous months due to the pandemic inducing strains on corporate lending among big borrowers. Despite this, lending from regional banks remains high as smaller firms continue to borrow heavily to meet immediate funding requirements. Most big companies already borrowed huge amounts of funds as a precautionary measure back in the spring and are now able to pay back their loans due to less uncertainty surrounding the pandemic. Total bank lending still rose 6.4% in September to stand at a record JPY 573.7tn. (Reuters)
Asia bonds beckon with compelling yields and a positive outlook **Oct 12.** Asian bonds are eclipsing their global peers as sovereign and corporate bonds are among the most attractive in emerging markets. The Asian market is forecasted to be the fastest-growing region in both this year and 2021 as Asian economies are expected to experience a more modest recession and a more robust recovery. However, one exception is the banking sector, particularly Indian banks whose first-half earnings have yet to showcase asset quality issues. Investment-grade bonds make up 80% of the market and despite the overall default rate being elevated compared to previous years, there is not expected to be a wave of credit downgrades. Government stimulus is critical to Asia's recovery and most Asian governments have sound and healthy financial positions. With a more favorable outlook, this could see the market pivot towards Asian debt. (Straits Times)
AMC rescue bonds hit in cinema crisis **Oct 11**. Investors who took a big risk lending money to the world's largest cinema operator in April face losses as USD 175mn was wiped from the bond's value due to the deepening impact of COVID-19. AMC issued USD 500mn at a 10.5% interest rate in April, however concerns over the survival of the company have seen the bond price reduced to 65 cents on the dollar making it the worst-performing rescue financing bond since the start of the pandemic. AMC's credit rating was also downgraded two notches down to CCC- by S&P earlier this month as the rating agency expects the company to burn through more than USD 100mn a month in cash despite them already opening the majority of their theaters. (FT)
Surge in green bonds issued in September **Oct 8.** Green bonds hit a record figure last month with USD 50bn issued as more companies and governments invested, a 500% increase from August. The value of green bonds this year has climbed to USD 176bn, a 26% increase from the same period last year. However, green bonds remain a small portion of the overall debt market, accounting for just 5% last year. The September boom was likely due to fact that operations were postponed earlier in the year due to the COVID-19 pandemic. However, there have been calls to improve the evaluation of projects that attain the green label as the risks of 'greenwashing' is still a persistent concern. So far, green bond projects have not necessarily translated to comparatively low or falling carbon emissions levels. (Straits Times)
Companies give up cash cushions to buy back debt **Oct 6**. Companies in the US and Europe are buying back bonds to reduce the cash piles that they built up earlier this year. This signals that expectations of more stable economic times are likely to follow. Many companies have overfunded and now realized that it is too costly for them. This has seen a 40% increase in

the value of bonds bought back in the US and a 50% increase in Europe, the Middle East and Africa compared to last year. Global corporate debt issuance has hit a record high in 2020 as US firms tapped the bond market for close to USD1.5tn in just September alone. In this low-interest rate environment, sitting on excess cash is expensive, as there is a difficulty finding an optimal use of capital. Many companies believe that they can always raise money again should the pandemic worsen and this would not be of much inconvenience due to the expectation that central banks will keep borrowing costs low. (WSJ)

Europe's record cash pile set to prime next stage of bond rally (Bloomberg)

University of Tokyo's maiden bond sale sells out by factor of six (Nikkei Asian Review)

Mexico's Pemex places bond to refinance debt, gets strong demand (Reuters)

Regulatory Updates

Canada launches new business rent aid program, expands other coronavirus support

Oct 10. Canada announced a new rent subsidy program that will run through June 2021 to replace the previously much-criticized rent-relief program. The subsidy program aims to help businesses that are facing revenue losses; with targeted support given to those businesses that are forced to close to help curb the impact of the pandemic. Furthermore, the Canada Emergency Wage Subsidy program had been extended to June 2021 and the Canada Emergency Business Account would be expanded to allow for larger, partially-forgivable loans. The three programs are expected to raise costs by CAD 19.6bn (USD 14.9bn) until December 2020. Trudeau's government said that the fiscal deficit is set to hit CAD 343.2bn, signifying the largest shortfall since WW2. (Reuters)

Bank of England tightens COVID corporate lending rules

Oct 10. The Bank of England (BoE) is set to tighten lending rules on the GBP 20bn program aimed at large corporations with investment-grade ratings prior to the pandemic. The Covid Corporate Financing Facility (CCFF) bought sterling commercial paper from companies that had 'top-notch' credit quality prior to the onset of the pandemic and are currently facing trouble in raising money due to incumbent macroeconomic conditions. Lending under the program peaked at GBP 20.5bn in May and has now fallen to GBP 15.8bn. The CCFF will close in March 2021, with further issuance of corporate paper into the CCFF being reviewed at the BoE's discretion, ensuring that companies that are still borrowing from the fund are using it appropriately. Businesses whose credit rating has deteriorated from investment grade will be limited to selling a maximum of GBP 300mn to the BoE, subject to the UK Finance Ministry's approval. (Reuters)

China to maintain "normal" monetary policy, PBOC chief says (Bloomberg)

Colombia central bank could add liquidity measures, policymaker says (Reuters)

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