Weekly Credit Brief Oct 20 - Oct 26 2020

Japanese banks face short-term credit risk as pandemic worsens asset quality and profitability

by Raghav Mathur

- **Worsening asset quality increases short term credit risk as seen by the Forward PD**
- **Though both types of banks face similar pressures on credit risk, regional banks are more exposed to domestic market conditions, while non-regional banks are exposed to global markets**

In our previous Weekly Credit Brief published earlier this month on the US banking sector, we mentioned that the sector's relatively strong foothold allowed it to take on near term credit risks. Our focus now shifts to the Japanese banking sector, exploring the sector's credit risk and the risks specific to regional[1] and non-regional Japanese banks[2]. Regional Japanese banks, which have already been battling structural challenges for the past few years, are now facing additional pressure on their short term credit health. This is due to the COVID-19 pandemic causing an increase in the expected number of non-performing loans (NPLs) in the near future. Meanwhile, non-regional banks are exposed to potentially worsening international assets increasing credit costs and reducing profitability. As seen from the NUS-CRI Aggregate (Median) Forward 1-year Probability of Default (Forward PD[3]) in Figure 1, Japanese banks demonstrate a worsening credit outlook within the next year for both regional and non-regional Japanese banks.

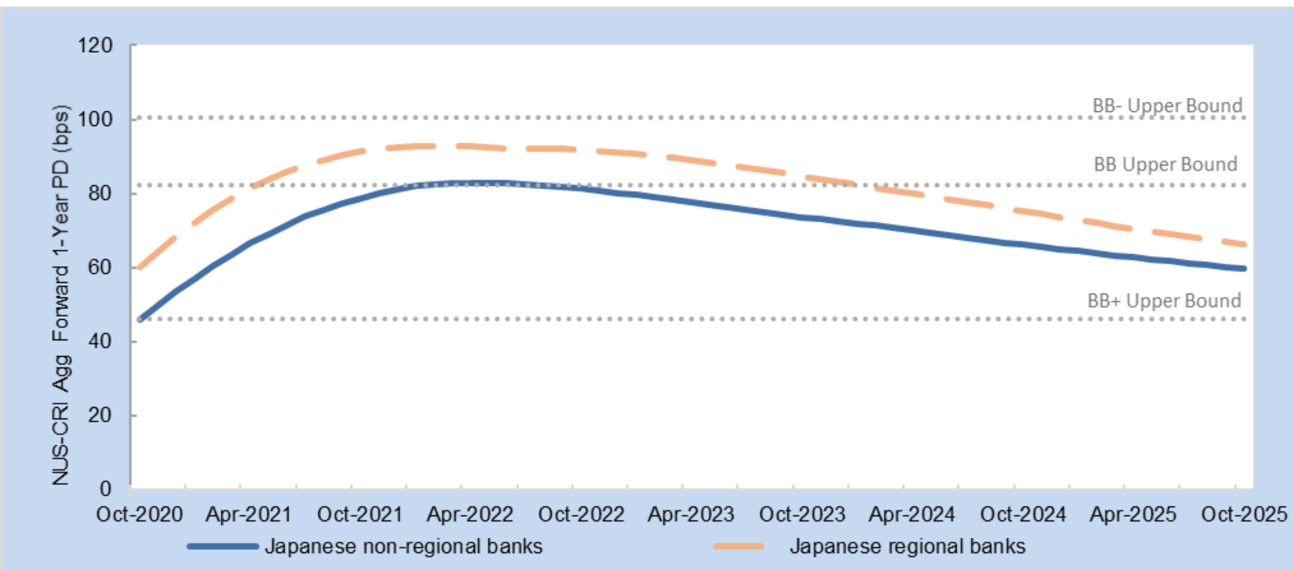

Figure 1: NUS-CRI Agg Forward 1-Year PD of regional and non-regional Japanese banks with reference to the PDiR2.0[4]. *Source: NUS-CRI*

[1] These banks are those that are publicly listed in Regional Banks Association of Japan.
[2] All other listed banks domiciled in Japan – On average, market capitalization of non-regional banks is greater than that of regional banks
[3] 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.
[4] 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.

The pandemic-induced economic slowdown has caused both regional and non-regional Japanese banks to face a potential increase in their NPLs. With an anticipation of an increase in NPLs in the near future due to slow economic recovery, regional banks increased their loan-loss provisions by 46% in Q1 2020. On the other hand, with increasing exposure to the global markets in recent years, non-regional banks have benefited from diversification which cushions them from worsening domestic conditions. Recently, however, the pandemic resulted in worsening global conditions, especially in the United States market. As Japanese banks have the most exposure to the US markets, they are facing higher expectations of future NPLs.

A mixture of slower exports, stronger yen and weak domestic demand has hindered economic growth and detrimentally affected the profitability of both regional and non-regional banks. Furthermore, a challenging macroeconomic environment, shrinking demand for loans in rural areas (structural challenges), a narrow interest rate margin and inefficient business operations further decrease the profitability for regional banks. As demonstrated below in Table 1, we can see a decrease in return on equity (ROE) and net interest margin (NIM) over the past few years in Japanese regional banks. Now, the pandemic-induced downturn exacerbates the pressure on regional banks' already strained profitability. For non-regional banks, there is also a reduction in NIM from 1.17% in 2015 to 0.96% in 2019 before bouncing back up in H1 2020 to 1.05% and in ROE from 6.98% to 2.61%, which are mostly driven by worsening overseas interest margins.

		FY2015	FY2016	FY2017	FY2018	FY2019	H1 2020
Regional banks	**NIM (%)**	1.16	1.12	1.10	1.07	1.02	0.96
	ROE (%)	5.32	4.31	3.94	2.90	2.70	2.68
Non-regional banks	**NIM (%)**	1.17	1.11	1.14	1.09	0.96	1.05
	ROE (%)	6.56	5.73	4.62	3.80	2.50	2.61

Table 1: Financial ratios of regional and non-regional Japanese banks from FY2015 to H1 2020. *Source: Bloomberg*

To make matters worse, a large amount of losses from investment portfolios are potentially waiting for the Japanese banking sector. With JPY 15tn of Japanese banks' holdings of government bonds and notes maturing in the next few years, diminishing returns in the domestic markets looks set to put extreme pressure for both regional and non-regional banks and might lead to them to turn to riskier asset classes to chase higher returns. Recently, Japanese banks have been holding riskier CLOs, high-yield bonds and risky equities, which are all now showing signs of stress due to the pandemic.

To combat domestic challenges, regional banks have started considering M&A activity to consolidate domestic overcapacity, weather future credit costs and reduce domestic competition. Furthermore, prospects of substantial US stimulus after next week's presidential election could aid in recovery in the global markets. As such, non-regional banks may soon find some relief on their NPLs and investment losses. Looking at the sector as a whole, Japanese banks are strongly lobbying to ease regulations surrounding the separation of the commercial and investment banking units. This 'firewall' rule currently restricts the sharing of information between the two arms and makes it difficult for banks to offer an integrated service. Lifting such regulations, though increasing potential conflict of interest, would help in decreasing information asymmetry and loan risk.

Credit News

Permira-backed debt collector Lowell pays up in GBP 1.6bn junk bond sale

Oct 24. Lowell Group, a UK based debt collector – a firm which purchase defaulted and profit from claiming the loans for themselves, has issued EUR 1.6bn dollar worth of non-investment grade bonds. Its rates offered a 6.25% premium over euribor. The lockdown halted litigation claims and bailiff actions which hampered the firm's ability to profit. Moreover, increasing credit risk resulted in elevated debt levels which made Lowell a hit board for short traders. However, Permira, Lowell's private equity sponsor, has provided cash support of over EUR 600mn signaling a vote of confidence for Lowell. (FT)

In China, not all triple-A-rated bonds are created equal

Oct 22. China has seen an increasing issuance of AAA bonds throughout the pandemic. As of mid-Oct 2020, over USD 2.7tn yuan-denominated debt was issued. In the US, triple As are awarded to the firms which are the most financially robust. This coveted grading is only awarded to Microsoft and Johnson and Johnson. In contrast, 57% of China's onshore corporate issuances have AAA ratings. The differences in methodologies are significant barriers to entry for international investors as the rating scale might not be the best for a blooming bond market. (WSJ)

Bond insurance returns to the muni market in a big way

Oct 22. Doubts on local government creditworthiness revived demand for the insurance industry. The proportion of newly issued municipal debt went up 2.41% from the pre-pandemic average. As officials work towards keeping the cost of borrowing down as a mean to support pandemic struck economies, investors are increasingly concerned with the willingness and ability of local governments to fulfill their debt obligations. Moreover, bond insurance can also be leveraged to attain lower rates – an added consideration that investors/borrowers can look into during their decision-making process. (WSJ)

AMC bonds fall despite theatre reopenings

Oct 22. In light of the COVID-19 crisis, investors are selling their bonds as they bet on AMC's inability to revive former revenue streams. The price on the USD 1.4bn bond due June 2026 has fallen by 4.81% as of end-Oct 2020. Currently, the firm is burning over USD 100mn of cash a month and is forecasted to dry up by early 2021. The overall industry is facing high fixed costs with little catalysts for sales as studios are reluctant to release new content in fear of low demand. The future outlook remains dim given poor demand, lack of new releases, and social distancing measures imposed by states.(WSJ)

China's US dollar debt market showing cracks from US sanctions and prospect of more

Oct 14. US-China tensions show no sign of abating after the threat of new US imposed tariffs and sanctions on Chinese firms revealed cracks in China's USD corporate debt market. This year, the US has designated 31 leading Chinese companies as "Communist Chinese military companies" and added another 24 to a list that bans US firms from selling to these companies without special licenses. This has forced investors to weigh their decision to invest in the Chinese corporate bond market due to the high risk of more companies being added to this list of sanctions. China's corporate bond defaults are expected to rise as companies are unable to obtain funding and continue rolling over their debt while their profits are hit by a slow recovery in their business. (South China Morning Post)

Malaysia's AirAsia secures USD 72mn loan from Sabah Development Bank (Reuters)

Buyers of Thai distressed assets plan big purchases as debt payment holiday ends (Reuters)

United throws 'kitchen sink' at investors to secure USD 3bn borrowing (FT)

Regulatory Updates

Canadian regulator says it will not renew special treatment of deferred loans

Oct 24. Canada's financial regulator has no plans to reinstate the treatment of loans deferred by banks as performing assets despite the number of COVID-19 cases having spiked, causing businesses to shut down again. This will likely lead to a spike in bad loans in the coming quarters. However, banks and insurance companies are now in a much better position to go back to the loan-by-loan assessment as they look to consider further extensions on a case-by-case basis. (Reuters)

Indonesia to extend loan restructuring incentives for banks to March 2022

Oct 23. Indonesia's Financial Services Authority will extend loan restructuring incentives for some banks until March 2022 to prevent bad loans from spiking due to the economic fallout from the COVID-19 pandemic. This comes in anticipation of the decline in debt quality due to the recent wave of loan restructuring. The measure will allow banks to avoid making provisions for souring loans for a year longer than originally set and aid in keeping non-performing loan ratios lower the regulator's threshold of 5%. (Reuters)

Turkey proposes debt and fine restructuring to support companies (Bloomberg)

China securities regulator issues rules to curb convertible bond speculation (Reuters)

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