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Weekly Credit Brief Apr 2 - Apr 8 2019

Caution remains on Italian banks' credit profile

by Anthony Prayugo

By the end of 2018, Italian banks managed to halve their non-performing loan ratio (NPL) from a sky high 20.3% in early 2016, to 10.0% (see Table 1). The introduction of its GACS scheme in 2016 by the Italian government and ECB's push for Italian banks to sell their NPLs to third party investors may have contributed in reducing Italian banks' NPL ratio. However, Italian banks continued high exposure to Italian government bonds, relatively higher NPL ratio and lower profitability compared to the other European banks might have caused Italian banks' credit profile to remain worse compared to their European peers. As shown in figure 1 below, the NUS-CRI 1-year Aggregate Probability of Default (1-year Agg PD) for 11 large Italian banks remains higher compared to other 34 leading non-Italian European banks. Since October 2018, the 1-year Agg PD for Italian banks even increased to around 30bps, higher than in early 2018.

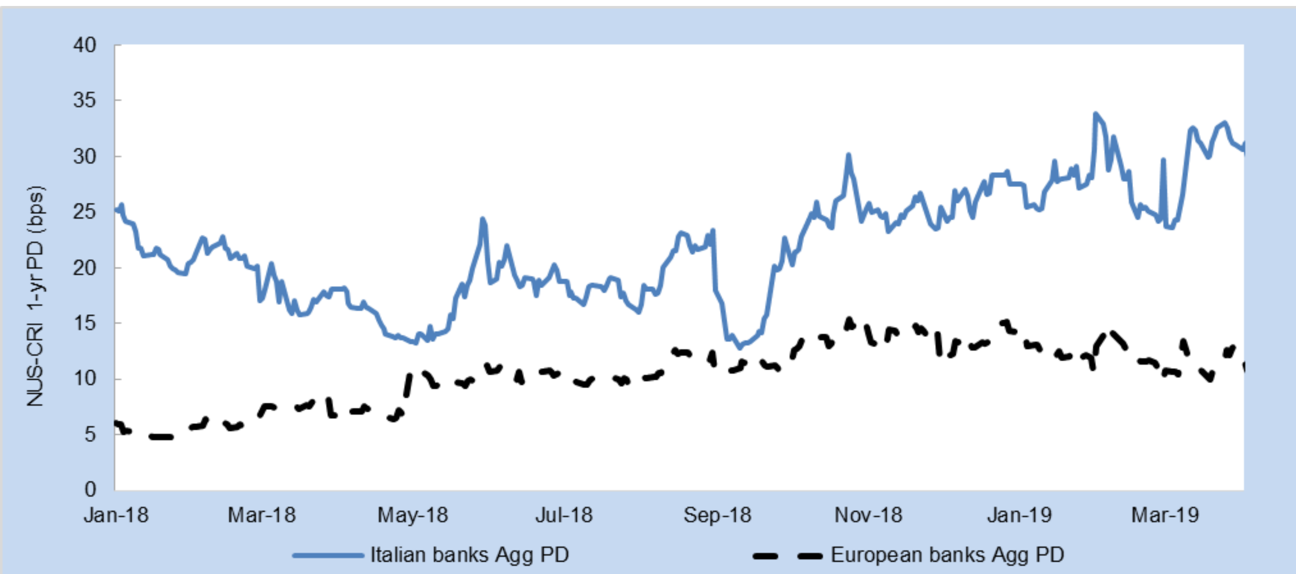

Figure 1: NUS-CRI 1-year aggregate PD for 11 Italian banks and 34 European banks (excluding Italy). *Source: NUS-CRI*

In January this year, Italian banks bought a net of EUR 11bn of Italian government bonds, the largest monthly increase since June last year. An increasing exposure to their sovereign bonds revived analysts' fears of a "doom loop" between the Italian government bonds and Italian banks' balance sheets. According to Bloomberg, Italian publicly listed banks currently hold approximately 25.6% of their sovereign bonds. This is equivalent to around 10% of their total assets, which is higher than most other European banks at 4%. The relatively large holding will be especially risky when the government debt prices fall as banks may have to reduce lending and raise capital to survive. Last year, concerns about Italian budget has pushed Italian bonds yield up to around 3.6% in November from around 1.7% in May. The Bank of Italy reported that Italian banks had seen a deterioration in liquidity and capital adequacy indicators during this period with Italian banks' average core equity tier 1 ratio falling and cost of new debt increasing.

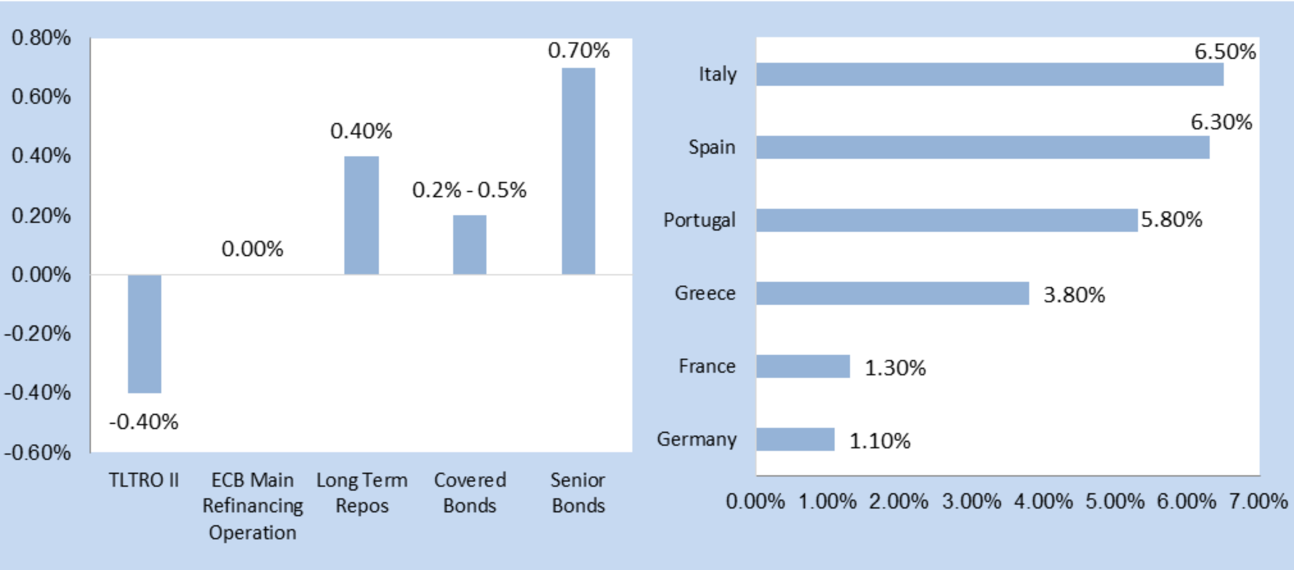

Figure 2: Cost comparison of existing longer-term funding for European banks (LHS) and TLTRO financing as percentage of banking assets by country (RHS). *Source: Bloomberg*

The upcoming maturity of the Targeted Long-Term Refinancing Operations II (TLTRO II) funds, cheap loans from the European Central Bank designed to stimulate European countries' economies, in mid-2020, also forces Italian banks to use other means to raise funding. Italian banks were the main beneficiary from the TLTRO II scheme. Currently around EUR 140bn of these TLTRO II funds are due to be repaid in mid-2020. Without replacing TLTRO II, Italian banks will see a drop in their net stable funding ratio. As shown in figure 2 above, Italian banks currently uses TLTRO financing the most with respect to their banking assets compared to other European countries. Out of the EUR 296.8bn of TLTRO II that has been drawn, Italian banks lead their European counterparts by a wide margin, drawing around EUR 183.6bn of TLTRO II funds.

Italian banks	2018 Q1	2018 Q2	2018 Q3	2018 Q4
Non-performing loans ratio (%)	16.7	12.0	13.4	10.0
Return on common equity (%)	7.5	7.6	7.6	6.9
Common equity tier 1 ratio (%)	12.4	11.6	12.1	12.0

Table 1: Financial ratios for 11 Italian banks. *Source: Bloomberg*

European banks	2018 Q1	2018 Q2	2018 Q3	2018 Q4
Non-performing loans ratio (%)	3.7	3.1	3.5	2.7
Return on common equity (%)	8.7	9.6	9.2	9.4
Common equity tier 1 ratio (%)	13.3	13.1	13.5	13.3

Table 2: Financial ratios for 34 European banks (excluding Italy). *Source: Bloomberg*

Indicators such as NPL ratio and profitability continued to show that Italian banks overall performance is still weaker compared to the average performance of other European banks. As demonstrated in NUS-CRI Forward 1-year Probability of Default (Forward 1-year PD) below, based on the information on April 5, 2019, the credit outlook for Italian banks could deteriorate the fastest within the first 12 months before stabilizing at around 42bps for the next 60 months. This steep deteriorating credit outlook within the first year coincides with the maturity date for their TLTRO II funds in mid-2020. The Forward PD computes the credit risk of a company in a future period, which can be interpreted similar to a forward interest rate. For example, the 12-month Forward 1-year PD is the probability that the firm defaults during the period from 12 months onwards to 1 year plus 12 months, conditional on the firm's survival in the next 12 months.

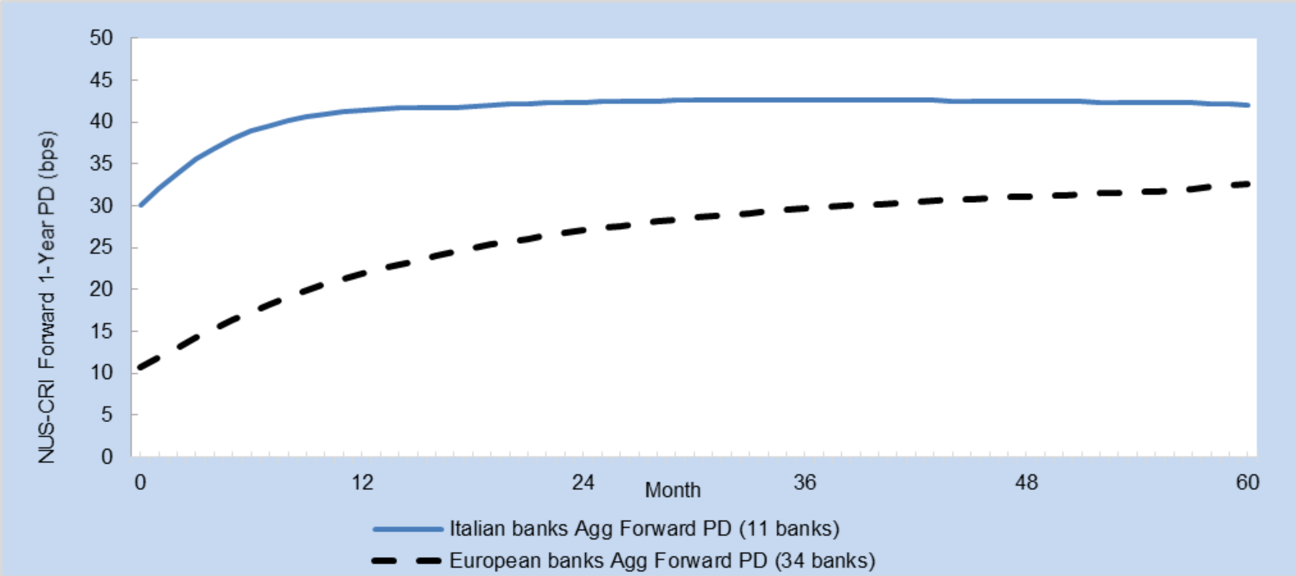

Figure 3: NUS-CRI Aggregate Forward 1-year PD term structures for Italian banks (median) and European banks (median) on 5 April 2019.
Source: NUS-CRI

After TLTRO II program expires, a new TLTRO III program will be introduced by ECB. While waiting for the new program to start, Italian banks may be forced to temporarily find other potentially more-costly financing to avoid a dramatic decrease in their net stable funding ratio. Recent signals from the departing ECB's president Mario Draghi, however, should have delighted Italian banks. Due to the gloomy global economic outlook from events such as Brexit and US-China trade war, the ECB is mulling to design TLTRO III as another new ultra-cheap bank loans. This new round of funding may ease some pressure on Italian banks from the upcoming TLTRO II expiry.

However, the anti-austerity and anti-European nature of the current ruling coalition can shake investors' confidence in the Italian government bonds, which Italian banks are highly exposed to. Combined with their lower asset quality compared to their European peers, Italian banks might need to exercise caution to maintain and improve their credit profile.

Credit News

Turkish banks sweat under rising pile of debt restructurings

Apr 8. The plunge in lira has put Turkish banks in a tough spot: with borrowings near record level and companies are faced with increased cost of servicing their foreign-currency debt. In addition, the recent jump in non-performing loans has increased the risk depleting the Turkish banks' buffers in the event of further economy contraction or plunge in lira. According to Bloomberg, corporate leverage in Turkey currently exceeds 40% of gross domestic product, almost double the average level when comparing it to the economies of Eastern European countries. (Bloomberg)

China's bond market is opening — but are the rating agencies ready?

Apr 5. According to ratings from Chinese rating agencies, 80% of Chinese onshore bond issuers are graded AA or above, a grade that is seen as a very strong ability to pay off its debts in global markets. However, Chinese bonds issued offshore are graded by global agencies six to seven notches lower than their ratings onshore. Chinese domestic rating agencies also issued more than twice as many upgrades as downgrades last year, when a record 45 corporate issuers defaulted on bonds. A senior management in the domestic rating agency thinks that China's rating system has not experience a market crisis and therefore the risks are not exposed yet. (FT)

Norway cuts emerging-market bonds from sovereign-wealth fund

Apr 5. Norway's USD 1tn sovereign-wealth fund will remove emerging-market corporate and government bonds from its fixed-income holdings, the country's finance ministry has announced. The reasons cited were high transaction costs, as well as the growing correlation between emerging and developed markets in general. Additionally, the finance ministry doubled the amount of money that the fund is allowed to invest in environment-related investments as part of its investment strategy. (WSJ)

Global debt edged up in 2018, debt ratio little changed: IIF

Apr 5. Global debt growth decelerated sharply in 2018 but debt to GDP remained little changed at about 390%. Among the countries, Japan, France and Australia experience increases in the ratio while debt ratios fell in Ireland, the Netherlands and Portugal. Debt grow at the fastest pace in the US since 2007, but strong GDP growth drove the debt to GDP to its lowest level since 2005 - though it is still high at 326%. Emerging markets' debt grew at the slowest pace since 2001 and the debt-to-GDP ratio was also steady at around 212%. (Reuters)

Asia tech companies fuel USD 23bn convertible bonds boom

Apr 3. The amount of Asian technology convertible bonds issued in the first quarter of 2019 has exceeded that of the whole of last year. A lack of debt funding options, higher interest rates, coupled with a lacklustre equity market has led to an increased issuance of convertible notes this year. With a convertible bond offering, companies effectively issue shares without an immediate dilutive effect, but at a premium price in a future date. Chinese firms that have recently tapped the Asian convertible note market include electric car maker Nio, iQiyi and Lenovo. (FT)

Saudi Aramco attracts USD 30bn demand for expected USD 10bn bond issue (FT)

Beijing's bank bailout better be bold (WSJ)

U.S. government-bond prices climb on global growth concerns (WSJ)

Regulatory Updates

Switzerland plans to tighten capital rules for its biggest banks

Apr 8. Switzerland's Finance Ministry is planning to tighten capital rules to ensure that the parent companies of systemically important banks are sufficiently well capitalized. These rules could potentially force UBS Group and Credit Suisse Group to set aside an additional CHF 24bn in reserves, thus increasing total refinancing costs for these 2 banks by as much as CHF 170mn per year. The Swiss authorities are worried that in the event of another financial crisis, the banks' capital cushions could be reserved for foreign locations and the remaining capital may not be sufficient for Switzerland. The last time the two lenders were asked to increase the amount and quality of capital was in 2016. (Business Times)

Draghi's ECB tackles negatives of contentious interest rate policy

Apr 4. ECB president Mario Draghi, whose term is due to expire in October, has hinted at opening up the doors for future discussion about the ECB's expansionary monetary policy. After the Eurozone deposit rate became negative in 2014 in a push of the ECB for accelerating economic growth, banks have been calling for a change of what they claim to be an unfair burden. One of the potential replacement options being discussed is a tiered system, in which parts of the banks' deposited money would accumulate at a positive rate. (FT)

India's supreme court strikes down central bank's corporate default rules (FT)

US regulators propose rule discouraging large banks from investing in competitors' debt (Business Times)

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