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Weekly Credit Brief Aug 07 - Aug 13

Royal Commission hits Australian financial sector, AMP Ltd hurt most

by Xu Zijun, Lisa

Established in December 2017 by the Governor-General of the Commonwealth of Australia after years of public pressure, the Royal Commission was set to investigate the misconduct in banking, superannuation and financial services industry. As of August 3, 7961 evidences of misconduct behavior by Australia's major banks and wealth managers have been heard, which include alleged bribery, charging clients service fees without service, etc.. Among the financial institutions that have been accused by the Royal Commission so far, AMP Ltd (AMP) has been the most hit by the misconduct due to its heavier reliance on the wealth management business (Figure 1a) – one of the key targets of the Royal Commission. Worse still, even before AMP got involved in the investigations from Royal Commission, its profit margin had already been on a decreasing trend (see Figure 1b below), as the company already faced structural trouble in its business. In 2017, the company announced a turnaround strategy plan to focus more on its wealth advice and superannuation business, however, the recent investigation from Royal Commission created headwinds for this.

AMP is the largest public wealth manager in Australia and one of the oldest financial institutions. AMP's business consists of wealth management, life insurance, banking, AMP Capital (investment), New Zealand financial services and Mature (management of closed products services). On the second round of hearing by the Royal Commission on April 16, AMP was blamed for failing to report its misconduct behavior such as on kickbacks to advisers which raised concerns on prohibited conflicted remuneration, providing of inappropriate financial advice and charging clients without service rendered. On April 17, there it became public that AMP had tried to mislead regulators for almost a decade. In fact, the fees being charged to customers after they stopped receiving advice turned out to be conducted intentionally and the practice had been approved by management. AMP admitted it had made 20 false statements to Australian Securities and Investments Commission to cover its overcharging behavior. This misconduct could now lead to severe criminal charges. Right after the scandal, AMP's CEO Craig Meller announced to step down and the chairman Catherine Brenner also resigned.

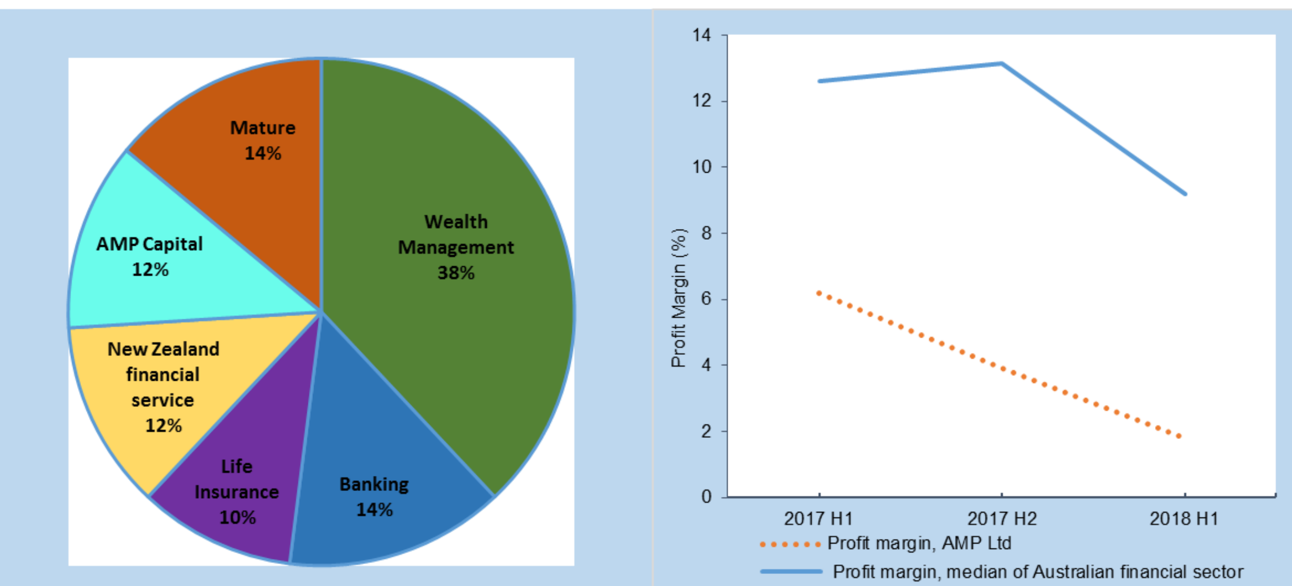

Figure 1a (LHS): Earning of AMP Ltd by different segments based on FY 2017 financial result. Figure 1b (RHS): Profit margin of AMP Ltd and median of 120 companies in Australian financial industry. *Source: Bloomberg*

Hit by the scandal, AMP experienced a net cash outflows of AUD 873mn due to withdrawals by clients in its wealth management sector during the first half of 2018 compared to AUD 1.02bn of inflow in the first half of 2017. Its net profit decreased to AUD 115mn which is the lowest first-half year profit since 2003 and the gap between the profit margin of the company and the industry median is greater (see Figure 1b above). On July 27, the company announced an AUD 290mn compensation to be set aside for its customers. AMP also announced fee reduction of around of 45 basis points on average for wealth management clients which is likely to further reduce AMP's revenue by AUD 12mn in the second half of 2018 and by AUD 50mn a year from FY 2019. What's more, AMP has to put more than 300 advisers on notice to discontinue their licences for financial advice under pressure of corporate watchdog probe, which may further hurt its ability to generate income with less advisers in its wealth management business. The market capitalization of AMP dropped more than 33.67% as of August 13, compared to April 13, the last trading day before the second hearing.

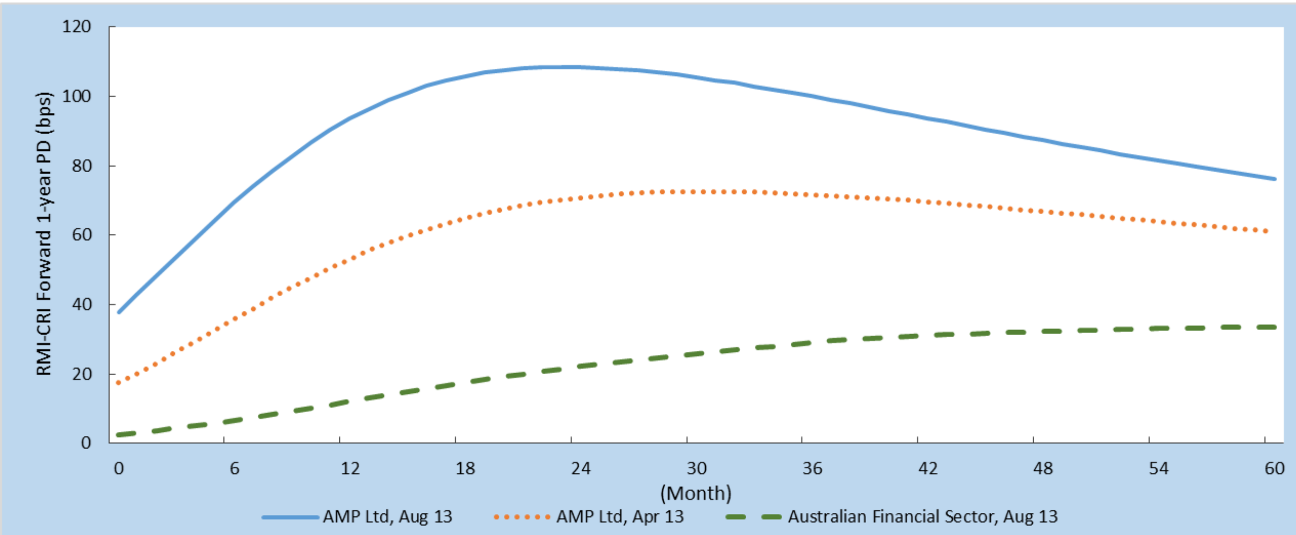

Figure 2: RMI-CRI Forward 1-year PD term structures for AMP Ltd & median of 120 financial companies in Australia and on August 13 and Forward 1-year PD term structure for AMP Ltd. on April 13, 2018. *Source: RMI-CRI*

The RMI-CRI Forward 1-year PD (Forward PD) term structure in Figure 2 above shows how the shape and level of Forward PD changed from April 13 to August 13. The move-up of the term structure reflects the negative impact of the scandal on AMP's credit profile, as the scandal has tainted its reputation which would take time to restore. The Forward PD works similarly to a forward interest rate. For instance, the 3-month Forward 1-year PD is the probability that the firm defaults during the period from 3 months onwards to 1 year plus 3 months, conditional on the firm surviving the next 3 months. Based on market information on August 13 the increasing Forward PDs for AMP indicate that the conditional credit risk of the firm lies above the industry level and will gradually increase as time passes and will reach its peak in about 2 years.

Till August 13, there are other misconduct cases by the biggest four Australian banks that have been exposed to public, such as the Commonwealth Bank of Australia and National Australia Bank charging fees to customers who were dead. National Australia Bank and Westpac have also made compensation when they breached a 2013 ban on banks and wealth management businesses from paying kickbacks to advisers. However, due to the banks' stronger profitability and less dependency on its wealth management service as compared to AMP, the credit profiles of these banks are not as affected as AMP's. Given the recent scandals and a large change to its board, AMP may face headwinds in the near future.

Credit News

China faces problem in getting its banks to lend more money

Aug 13. Despite the People's Bank of China's effort to loosen monetary policy, most of the funds are sitting idle instead of being channeled into the wider economy. The demand and supply of loans remain subdued. Banks are still concerned about the increasing credit risks amid a slower China economy and the worsening trade war. In addition, the government is still focusing on the deleveraging campaign which has seen state firms' borrowing being scrutinized and a cleanup of shadow banking and property curbs. Non-banking funding channels are also becoming more expensive which are typically used by smaller companies as commercial banks have cut their holdings of corporate bonds in July. (Bloomberg)

Greek banks face higher costs post-bailout as ECB ends waiver

Aug 10. Greek lenders may face higher financing cost after the ECB stops accepting Greek sovereign bonds as collateral when it lends to the banking sector. The central bank announced that non-investment grade bonds will be excluded from the list of securities that can be used as collateral, meaning that any Greek bank that holds junk rated bonds will be unable to use them to borrow cheaply from the ECB. Greek debt securities are rated below investment grade by all rating agencies and lenders may have to access more expensive funding avenues such as the interbank market for liquidity when the waiver ends on Aug 21. (Bloomberg)

As Turkey crisis mounts, contagion jitters hit global banks

Aug 10. The turmoil in Turkey and Russia has caused concerns in the financial system especially among the European lenders such as Spain's BBVA and Italy's UniCredit which have seen their share prices plunged. Concerns among investors are that the weakening currencies in Turkey and Russia and the increasing potential of loan defaults in these regions may have a contagion effect across the financial system and may hit banks even with little to no direct exposure. Some of the US banks such as Citigroup and Goldman Sachs have seen their share prices fall. Turkish lenders are already in talks to restructure loans worth billions of dollars which may force them to accept losses and eventually seek capital from their European partners. The fragile Turkey economy is further threatened by sanctions from the US and Turkish regulators from the financial industry plan to meet its banks to look at the impact of interest and exchange rate shocks. (Bloomberg)

Musk plan to privatize Tesla pushes USD 2.3bn of debt above conversion price

Aug 8. Tesla's plan to become a private company has pushed the value of its stock above USD 360, allowing its convertible bond holders the right to convert their notes into equity. If the stock stays above the conversion price of USD 359 per share, Tesla has the option of paying off its debt obligation in stock instead of cash. With nearly USD 9.5bn of debt on its balance sheet, the option of redeeming debt with equity may help relieve some of the company's debt burden as Tesla has been burning cash to meet its Model 3 production targets. (Reuters)

Singapore banks brace for chill from mortgage slowdown

Aug 7. Singapore banks are bracing for a mortgage slowdown in the coming years due to the latest property cooling measures. DBS has cut its property loans growth forecast by SGD 1bn, having originally anticipated SGD 4bn growth. UOB and OCBC have also experienced a slowdown in their housing loan activities, with OCBC reporting a 10% decrease in activities in July. However, the cooling measures are not expected to hit UOB's property loans growth at the moment, given the progressive drawdown of loans booked previously. Similarly, OCBC still expects overall mortgage growth of a low to mid single-digit percentage this year, as loan demand from first-time home buyers remains relatively resilient. The potential growth slowdown from the cooling measures may be offset by a greater net interest margin caused by a rise in Singapore Interbank Offered Rate. (Business Times)

Jet Airways says debt is serviced on time despite cost pressures (Bloomberg)

World Bank to issue world's first blockchain bond (Business Times)

Turkey central bank takes steps to support banks as Lira slides (Bloomberg)

Regulatory Updates

China proposes 10 measures to fight against rising P2P risks

Aug 12. Chinese authorities are proposing 10 measures to curb rising risk in China's financial system caused by the troubled peer-to-peer (P2P) lending sector. Since June 2018, 243 online lending platform have gone bust due to the intensifying crackdown on shadow banking conducted by a central government work group to reduce such risks. The proposed new measures include conducting compliance inspections on P2P companies and strictly banning local authorities from allowing the set-up of new P2P companies or online finance platforms. In addition, borrowers who avoid P2P loan repayments would be blacklisted in China's social credit ratings system. The government will also find ways to resolve P2P liquidity risks, protect the legal rights of investors and increase public awareness of the risks. (Reuters)

Finance watchdog relaxed about bank models after Brexit

Aug 9. In contrast to other European regulators, the UK financial regulator, Financial Conduct Authority (FCA), informed banks that it is sanguine about the model banks use to book risk and profit as they move their business to the EU after Brexit. The ECB on the other hand has set out specific requirements regarding the business model, for example warning against the use of back-to-back booking, which is when products are sold by an entity in EU before the risk is transferred to the UK via an internal trade. There are several more issues where regulators on both side clash which have left firms in uncertainty. (FT)

Australia grants invasive new power to financial regulator (Business Times)

US regulators warned against reducing bank capital requirements (FT)

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