Credit Research Initiative
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Weekly Credit Brief Dec 22 - Dec 28

Brazilian banks – too burdened to samba

by KHAW Ker Wei

The RMI-CRI aggregate 1-year Probability of Default (PD) for Brazilian banks (measured by the median value of PD for 17 banks in Brazil) hit a historic high of 193bps in the final quarter of 2015, as the country grappled with what could be the worst recession since the Great Depression. Brazil's GDP fell by a record 4.5% year-on-year in Q3 2015. Its annual inflation rate in 2015 came in at a staggering 10.8%, more than double the government's target, while the unemployment rate had soared to 7.5% by November 2015, from just 4.9% in October last year. Indeed, the situation was so bad that Brazil, as the organizers of the 2016 Summer Olympics, proposed to make athletes pay for the air conditioning in their dorm rooms. (The decision was promptly reversed the next day.)

While the Brazilian banks remained adequately capitalized as of the close of the latest reporting cycle, the ailing economy creates a challenging business environment going into the next year. Already, loan delinquencies are on the rise. In November 2015, the number of loans overdue for at least 90 days climbed to an equivalent of 5.2% of outstanding non-earmarked loans. At Banco do Brasill and Itau Unibanco, the two largest banks in Brazil by total assets, the ratio of non-performing assets have crept upwards. Itau Unibanco's net charge-offs of 6.8%, booked for Q2 2015, was the highest in a decade (see Figure 1).

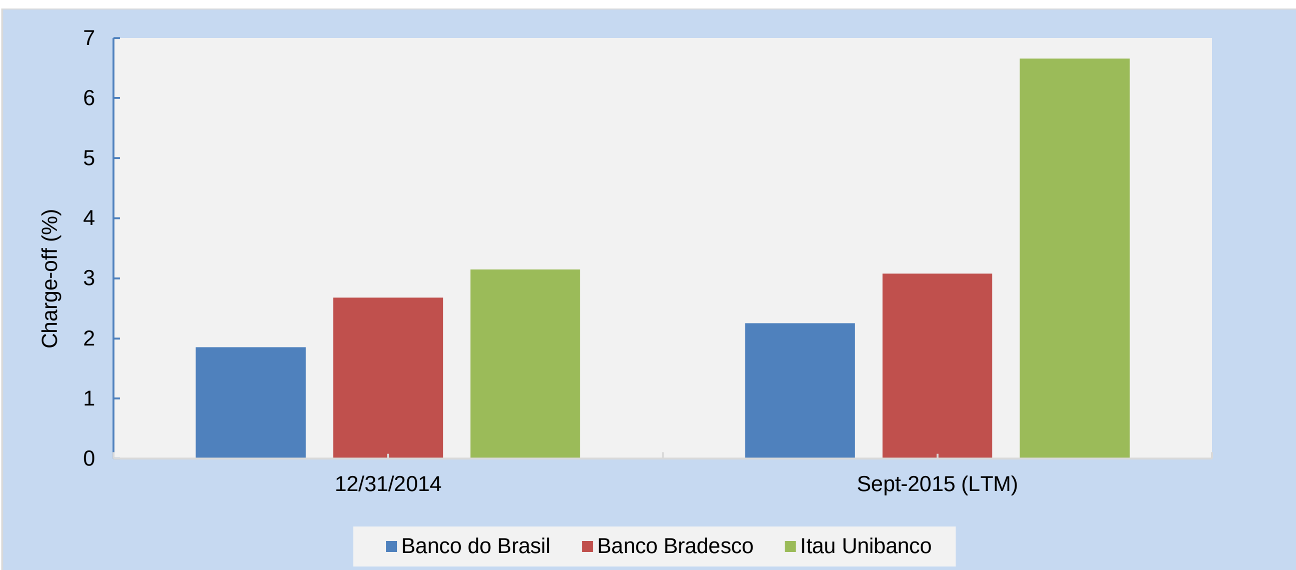

Figure 1: Charge-offs booked by Brazil's biggest banks by total assets as of 28 Dec 2015 *Source: Bloomberg*

Itau Unibanco's decision to write the loans off came amidst the biggest corporate scandal in Brazilian history. The scandal involving the national oil company Petrobras was uncovered back in March 2014 and remains unresolved until today. The federal investigations led to a spillover on smaller companies linked to Petrobras. Several companies have already filed for bankruptcy protection after being locked out of the credit markets or losing business. Worse still, just beyond the Petrobras scandal, another one looms over the horizon – a corruption scheme that involves the nation's largest utility Electrobras. It threatens to stretch the investigation and add to the list of companies filing for bankruptcy. As it is, the soundness of the Brazilian banking system is set to be tested further as bad assets continue to grow.

Up until the third quarter of 2015, the major Brazilian banks remained profitable. However, credit rating downgrades by leading rating agencies during the final quarter of the year would heap some downward pressure on that measure. The round of credit rating downgrades kicked off in September 2015 when Brazil's sovereign credit rating was downgraded to junk. Due to the inter-dependency between these institutions and the financial health of the nation, the credit rating for banks were also cut across the board. The rating cuts are expected to lead to higher credit costs, which in turn, narrow the net interest margin of banks. For smaller banks that are less adequately capitalized, the mounting losses from bad loans and the shrinking profits may lead to serious problems.

The bleak business environment provides little for bank shareholders to look forward to in 2016. Along with the wider Ibovespa Sao Paolo Stock Exchange Index, the market capitalization of the major banks in Brazil have shrunk significantly, in particular that of Banco do Brasil. The bank is now only a shadow of its former self. Valued at BRL 91.9bn during its peak in 2010, its market capitalization had fallen to BRL 42.6bn as of 28 December 2015, sparked by selloffs resulting from Brazil's sovereign credit rating downgrade. As a result, Banco do Brasil's RMI-CRI 1-year PD surged to 674bps on 23 December 2015, the highest among its banking peers (see Figure 2).

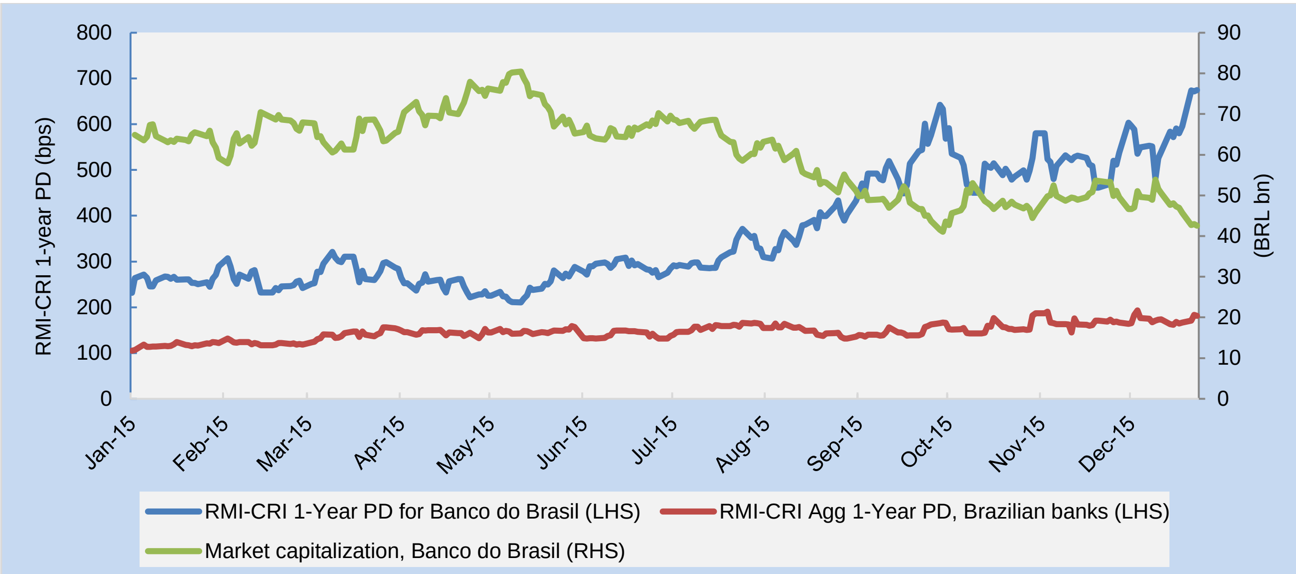

Figure 2: RMI-CRI 1-year PD, market cap of Banco do Brasil and RMI-CRI aggregate 1-year PD of 17 Brazilian banks
Source: RMI-CRI, Bloomberg

Brazil's present problems are manifold and each, too deep to be resolved on its own. At a time when strong commitments and refreshing policies are needed, the ruling government finds itself entangled in a corruption mess that is already hurtling the country towards a lost decade. Inevitably, as part of the system, the Brazilian banking sector will not be spared. For now, Brazilians can find comfort in the fact that their banks have proven resilient so far, with comfortable liquidity ratios and adequate loan loss reserves coverage. However, as the crisis drags further, the strength of the banking sector is bound to weaken.

Credit News

Top Asia junk bond funds all bought China builders after default

Dec 28. Top performing junk bond funds in Asia all profited from China's property debt this year. They were able to benefit from these opportunities as China aims to prevent rising delinquencies from sparking a crisis. In reaction to the slump in the property market, which account for approximately one third of China's economy, Premier Li Keqiang relaxed rules on mortgages and allowed builders access to domestic bond market for financing. China's leaders also signalled last week that they will take steps to support growth, including widening the fiscal deficit and stimulating housing. According to Bank of America Merrill Lynch index, Chinese developers and other Asian high-yield bonds have generated a total of 4.2% return this year. (Bloomberg)

UK economy loses momentum as pace of growth revised lower

Dec 23. The UK economy expanded less than previously estimated over the past two quarters, signalling that growth is losing some momentum. GDP growth rose by 0.4% between July and September instead of the previous estimation of 0.5%. This revision indicates a loss of momentum in an economy that heavily relies on consumers and domestic demand. Although the economy is forecasted to grow at 2.3% next year, matching 2015's pace, economists based on a Bloomberg survey highlighted that a British exit from the European Union as a possible threat to the UK outlook. The UK's economy performance in the latest three months matched its weakest since 2012 and compared with quarterly growth that averaged 0.7% last year. The Bank of England held its benchmark interest rate at a record-low 0.5% this month. (Bloomberg)

Cosco Singapore explores ways to help shipbuilding business

Dec 23. In view of the slump in commodities trading and oil prices, which leads to sluggish demand for new vessels, Cosco Corp is exploring further options to support its worsening business outlook. Cosco's subsidiary China Shipyard Group is considering expanding its funding sources and optimizing its asset structure. The shipyard anticipated significant net loss in Q4 as a 39% decline in bulk shipping rates has hit demand for new ships and led some customers to withdraw from existing offers. Furthermore, customers are asking shipbuilders to delay delivery of offshore drilling rigs amid a slump in oil prices. The Singapore company reported a loss of SGD86.1mn for the first nine months of this year, a major setback as compared with profits of SGD34.1mn a year ago. (Bloomberg)

Worst Korea downgrade ratio since 1998 spurs riskiest bond sales

Dec 23. Korean companies have been forced to sell riskier hybrid securities to boost their balance sheets as South Korea's debt rating downgrades has outpaced upgrades by the most since 1998. Downgrades were speculated to continue into the first half of 2016 because of the economic slowdown and the depreciation of the JPY against the KRW. Kim Sang Hun, a credit analyst at Shinhan Investment Corp, claimed that selling hybrid securities is the optimal way for companies to defend their credit rating, though it is more expensive. He also added that hybrid sales would increase in 2016. (Bloomberg)

Toshiba's credit rating lowered two levels to junk by Moody's

Dec 22. Moody's has downgraded Toshiba's long term senior bond rating by two levels to Ba2, which is Moody's second-highest junk rating. This move echoed an earlier downgrade by S&P to sub-investment grade. The short term rating of the Japanese conglomerate was also cut. Toshiba's announcements of its structural reform plan and financial forecast were the impetus for the recent downgrades. Masako Kuwahara, an analyst in Moody's, stated that Toshiba's leverage level would remain high over a protracted period as the restructuring costs will overshoot Moody's initial estimates and any improvement in earnings will be gradual. Toshiba forecasted a record JPY 550bn loss for the current fiscal year, after an accounting scandal and plans for restructuring. (Bloomberg)

Oil drop threatens to push energy groups into liquidation (FT)

Eurozone economists sceptical of more ECB asset purchases in 2016 (FT)

Global steel industry eyes India lifeline (FT)

Regulatory Updates

Chinese regulators checking on China Vanke fight

Dec 27. Chinese regulators are investigating the battle for control of China Vanke, the largest developer in China, for any violations of disclosure requirements to ensure the interest of all shareholders. The takeover battle has heated up since December 4, when property and insurance conglomerate Baoneng became Vanke's biggest shareholder after its subsidiary bought a combined 20% stake (subsequently increased to 24.26%) in China's biggest homebuilder. The Shenzhen Stock Exchange complained about disclosure differences between Hong Kong and Shenzhen, both of which are the bourses China Vanke is listed in. It even claimed that the difference has misled media and investors. (SCMP)

Chinese lawmakers pave way for start of market-based IPO system

Dec 27. Chinese lawmakers cleared the way for securities laws to be changed as early as March for the nation to introduce a new registration system for initial public offerings (IPOs). The new regime would be more market-oriented and could thoroughly change the investment-banking operations of China's brokerages by giving them more power to determine IPO pricing and by boosting their business volumes. (Bloomberg)

Caution urged for Hong Kong bankers as suitability rule enforced (Bloomberg)

Banco Santander says it exceeds new ECB capital requirement (Bloomberg)

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