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Weekly Credit Brief Feb 09 - Feb 15

Deutsche Bank in the eye of a financial storm

by Samuel LIM Kok Hong

If 2016 has been bad for the global stock market, it has been cataclysmic for banking stocks. US financial stocks tumbled by almost 20%. In other parts of the world, the decline has been even worse. Japanese and European banking stocks have nosedived by more than 35% and 30%, respectively. The recent weakness in banking shares can be attributed to market fears about the global economic slowdown, which would have a major effect on banks as countries move to lower interest rates in order to stimulate the economy. Lower interest rates would result in lower profits for the banks as they have to charge lower rates on their loans. Regulations are also going to be an obstacle for banks; the Basel Committee on Banking Supervision said on Jan 14, that by 2019, the banks have to maintain capital for their trading books on an average of 40% higher than they hold now.

Deutsche Bank, Germany's biggest lender, has not been spared from the financial storm. Its share price plunged to a 30-year low on Feb 9 and its decline has outpaced those of US and other European banks since the beginning of the year. The plunge in the stock price echoed the selloff in the European banking sector amid market concerns about capital buffers in banks and the poor market outlook for banks. Deutsche Bank still faces major legal challenges and could face fines amounting to billions of dollars in the future. The credit rating of Deutsche Bank AG's debts was cut by S&P on Feb 11 due to concerns that the bank could report losses in the future which would hinder the bank from paying on its debt obligations. The grade on the bank's CoCo bonds was downgraded from B+ to BB- and the perpetual Tier 2 instruments were cut from BB to BB-. While the CEO of Deutsche Bank claimed that the bank is rock solid and expects to make interest payment on the CoCo bonds, he did not seem to reassure debt holders as the CoCo plummeted to 70 cents on the euro last week.

On Jan 28, Deutsche Bank reported its first full-year loss since the financial crisis. The bank suffered a Q4 2015 net loss of EUR 2.1bn and a full year net loss of EUR 6.8bn due to the disappointing performance of two of its main revenue drivers, Corporate Banking & Securities (CB&S) and Private & Business Clients (PBC). The revenue from CB&S in Q4 2015 plunged by 30% YoY because of valuation adjustments of its financial instruments, poor trading environment and fewer client trades. Also, the non-interest expenses in CB&S went up by 19% YoY as a result of legal cost incurred for dealing with US-sanctioned countries, expenses incurred in complying with the new Basel III regulations and FX movements. The revenue from PBC in Q4 2015, which declined by 7% YoY, was impacted by adjustments on its investments in Hua Xia Bank and lower deposit revenues in a low interest rate environment. Non-interest expense in the segment surged by 26% in the same quarter mainly due to restructuring and severance costs of PBC's branch network.

The bank's financial ratios appear to be weakening. Tier 1 capital ratio declined mainly due to an increase in the risk-weighted asset from Q4 2013 to Q4 2015. The loss made by the firm in the latest quarter is reflective of its return to assets, which turned negative. The cost to income ratio has increased substantially in 2015 as the restructuring and legal costs have begun to take their toll on the firm's profitability.

	2013 Q4	2014 Q4	2015 Q4
Tier 1 Capital Ratio (%)	16.90	16.10	14.70
Return on Assets (%)	0.04	0.10	-0.41
Cost to Income Ratio (%)	117.61	93.58	141.05

Table 1: Deutsche Bank's financial ratios. *Source: Bloomberg*

All of these factors have propelled the RMI-CRI 1-year Probability of Default (PD) for Deutsche Bank from 55.97bps on Dec 1, 2015 to 103.65bps on Feb 12, 2016 (See Figure 1). The market capitalization of the firm was significantly impacted by the profit warning and reported earnings released for Q4 2015 in January despite a recent short term rebound due to the bond buyback announcement.

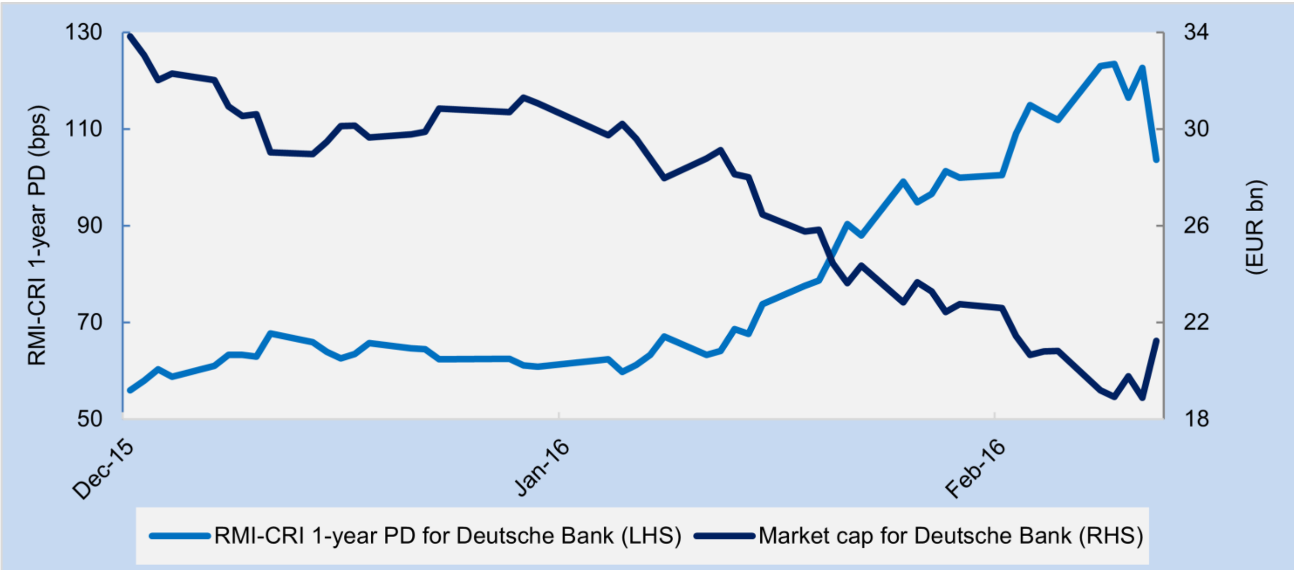

Figure 1: RMI-CRI 1-year PD and market cap for Deutsche Bank. *Source: RMI-CRI, Bloomberg*

As many perceived risks still lie ahead, it is understandable for investors to dump Deutsche Bank's shares. Against the backdrop of the falling share price and market confidence, the CEO of Deutsche Bank has taken steps to improve the financial health of the firm. Deutsche has planned to cut 2015 bonuses, slash 26,000 jobs, sell off assets and divest from 10 countries. However, it remains to be seen if these drastic measures will be able to turn the tides for the German banking giant, and if these changes come soon enough.

Credit News

Japan GDP drops 1.4% in fourth quarter

Feb 15. Japan's economy shrank at an annualized rate of 1.4%, worse than market consensus of a fall of 1.2%, in the fourth quarter of 2015. The negative result suggests that Japan is still plagued by the weakness of domestic demand as it enters a fourth year of record monetary stimulus. The wages have not been rising fast enough to persuade consumers to spend. While business investment and exports have performed well in the last quarter, consumption fell at an annualized rate of 3.3% in Q4. Public investment also contracted at an annualized rate of 10.3%, indicating that the fiscal stimulus of Abenomics has turned into austerity. (FT)

Pakistan default risk surges as USD 50bn debt bill coming due

Feb 15. The market is worried that Pakistan will default on its debt just as it starts to revive investors' interests with a reduction in terrorist attacks. Prime Minister Nawaz Sharif has worked to make Pakistan more investor-friendly since securing a USD 6.6bn IMF loan in 2013 to avert an external payments crisis. The five-year credit default swaps of the country's debt surged 56 bps over the past week, as about 42% of Pakistan's outstanding debt, roughly USD 50bn, is due to mature in 2016. According to Fitch, because short-term instruments accounted for a large portion of Pakistan's public debt, the country's debt paying ability is very sensitive to market conditions. (Bloomberg)

Palm exports from top producer seen tumbling most since 2014

Feb 11. According to data from the Indonesian Palm Oil Association, palm oil shipment from Indonesia has declined the most in two years in the month of January. The falling supply from the world's top producer have help to extend gains in futures as it surged 38% from a six-year low in August. Exports plunged by 22% to 1.97mn metric ton from December. Joeliano, trading director at PT Sinar Mas Agro Resources and Technology stated that domestic demand for the commodity is increasing and its supply is limited due to El Nino and seasonal factors. (Bloomberg)

Shipping firms swamped in trade slowdown

Feb 10. In the past, bigger shipping firms used their size and ample cash reserves to out-navigate their smaller competitors in a lower freight rate environment. However, the current global economic slowdown has begun to take its toll on these bigger firms, with no respite in the near term. AP Moeller-Maersk A/S, the biggest container-ship operator, reported a fourth-quarter net loss. The company claims that the challenging global economy has changed the near term outlook of its businesses. Last month, the IMF lowered the growth forecast for this year's global trade volumes to 3.4% from 4.1%. It also reduced the outlook for 2017 to 4.1% from 4.6%. (WSJ)

S&P cuts ratings of four US banks on worsening energy loans

Feb 9. Four US banks with large exposures to the energy sector have been cut by credit rating agency S&P on Feb 9. The long term ratings of BOK Financial Corp, Comerica Inc, Cullen/Frost Bankers Inc and Texas Capital Bancshares have been lowered and all four outlooks have been revised to negative. S&P expects loan losses at the banks to rise over the next few years even if oil prices rise modestly from its present level. In November last year, US regulators said that the banks' exposure to the oil industry and junk rated companies increased 9.4% from a year earlier and remained high at approximately USD 372.6bn. (Reuters)

Britain's biggest companies warn of Brexit risks on eve of EU referendum (The Telegraph)

Rio will cut dividend after metals rout sees profit tumble (Bloomberg)

Credit Suisse slides to 27-year low amid selloff, overhaul (Bloomberg)

Regulatory Updates

BlackRock says no need to stress test mutual fund sector

Feb 15. The Bank of England's plans to stress test mutual funds have been frowned upon by Ms Barbara Novick, Blackrock's vice chairman, as she said that the tests will not produce meaningful results. In December last year, the Bank of England was concerned that large scale investor redemptions could result in sales of assets by mutual funds that might impair the market's already weakened liquidity. The central bank conducted a survey among fund managers and found that the participants were overly optimistic about their ability to cope with large investment withdrawals. Blackrock does not see a problem in meeting redemptions but suggests that the central bank stress test individual funds instead, as this would give a more complete evaluation of the overall market structure. (Channel NewsAsia)

Saudi Arabia said to ease bank loan rules to boost liquidity

Feb 14. The Saudi Arabian Monetary Agency has increased the bank lending limit to 90% of deposits in a move to ease liquidity conditions in the banking system. The three-month Saudi Arabia Interbank rate climbed to the highest level in seven years as the central bank expects deposits to grow at a slower pace in 2016. Regulators have taken unprecedented steps to narrow the largest budget deficit since 1991 by raising fuel prices and cutting public spending this year. The kingdom's reserves dropped by USD 115bn in 2015 due to the drop in oil prices and foreign capital outflows. (Bloomberg)

UAE lenders can now access borrowers' credit history via their Emirates ID cards (The National)

British regulators yet to ask banks to assess Brexit impact (FT)

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