Credit Research Initiative
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Weekly Credit Brief
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Deflation fight weighs on Danish commercial lenders

by Justin Hsiao

While central banks are trying to stave off deflation in European economies by taking extreme action, some regional commercial lenders have been affected by these moves. As the oil price has plummeted and pushed the overall consumer price index lower, the Eurozone's inflation rate has dropped into negative territory in January to -0.6% - a record low after the financial crisis. In order to fight the falling prices in the region, in recent years many European monetary policy authorities including the European Central Bank, the Swiss National Bank, and Nordic central banks have set negative deposit rates for banks. On Thursday last week, Sweden's Riksbank announced a USD 1.2bn quantitative easing program and became the first central bank to set a negative repo rate - cutting it by 10bps to -0.1%. On the same day, Bank of England policymakers who had earlier considered raising interest rates, agreed to keep interest rates at the same level, given the concern that inflation could turn negative in the coming months.

A lower interest rate could decrease the incentive of banks to hoard cash and encourage people to consume or invest thus boosting the economy; however, it can also lead to a narrower interest rate spread, i.e. the gap between deposit and loan rates, which is a main source of profit for commercial banks. The NUS Risk Management Institute has detected a significant increase in the average RMI 1-year Probability of Defaults (RMI 1-year PDs) of 23 listed Danish commercial banks from 65.26bps at the beginning of 2014 to 105.71bps on February 16, 2015 (shown in Figure 1), which indicates a deteriorating credit profile within this sector.

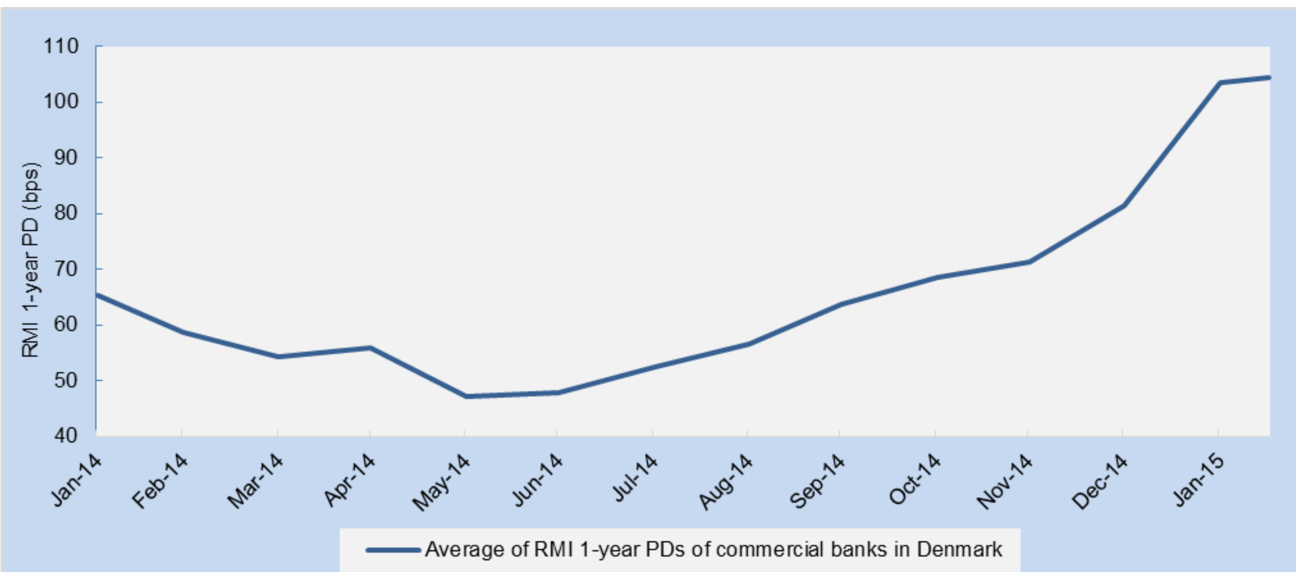

Figure 1. Average of RMI 1-year PDs of 23 listed commercial banks in Denmark. *Source: Risk Management Institute*

Unlike other Nordic countries, negative interest rate is not new to Denmark, as it had been adopted by the Danish central bank back in July, 2012. The Danish krone's peg to Euro is considered to be a cornerstone of economic policy in Denmark. However, this fixed exchange rate regime came under severe stress as the ECB introduced its quantitative easing in January. To prevent investors from hoarding AAA-rated Danish assets and defend the peg, the Danish central bank had implemented rate cuts four times within only 18 days. On February 6, the benchmark deposit rate was cut to a record low of -0.75%, which means it costs commercial lenders to keep money in the banks rather than lending it. Some lenders said they may start charging some of their depositors.

The long-time low interest rate and the recent radical rate cuts are hard for commercial banks to digest. Unlike commercial lenders in other countries in Europe, such as the UK or Switzerland, Danish lenders are less globalized and less diversified. Many Danish lenders are regional banks that rely more on depositary business to consumers and corporates, and are reported to be heavily affected. Danske bank, Denmark's largest lender, said negative rates would cost it a net USD 31mn in 2015. According to a Bloomberg estimate, Danske's gross loss would be around USD 190.22mn.

	Q1 2013	Q2 2013	Q3 2013	Q4 2013	Q1 2014	Q2 2014	Q3 2014
Average Net Interest Margin (%)	3.86	3.80	3.72	3.69	3.71	3.64	3.70
Average Cash/ Total Asset (%)	2.70	1.96	1.34	1.49	1.60	1.20	0.80
Median of RMI DTD	2.30	2.38	2.61	2.78	3.22	3.11	2.83

Table 1. Credit metrics for 23 Danish commercial banks. *Source: Risk Management Institute, Bloomberg*

Table 1 shows that the average net interest margin of 23 Danish commercial banks has dropped from 3.86% in Q1 2013 to 3.70% in Q3 2014. The net interest margin is a measure of the difference between the interest income generated by banks and the amount of interest paid out to their lenders, relative to the amount of assets. The decrease of this measure demonstrates the weakening ability of banks to generate profits from the interest spread. Besides, the average cash over total asset ratio of these lenders also slumped in the same period, from 2.70% to 0.80%. Additionally, the RMI distance-to-default (RMI DTD) measure had decreased over this period from 3.22 in Q1 to 2.83 in Q3. The RMI DTD is a volatility-adjusted leverage measure, and changes in the measure are a significant determinant of RMI 1-year PD.

On February 5, Danish central bank governor, Lars Rohde stated that they were, "aware of the negative impact on the profit-and-loss of the financial industry. But for the moment, we are concentrating on the currency." This suggests that a negative interest rate could last longer if needed. With Denmark joining the deflation club in January, consumers are expected to borrow less money from the banks, leading to a decrease in consumer borrowings. Overall, the credit outlook of the Danish commercial bank industry remains negative.

Credit News

Puerto Rico casts shadow over muni market

Feb 16. Investors are worried that Puerto Rico might not meet its debt obligation as yields on the state's 30 year bond rose to 8.06% last week. This is significantly higher than other AAA rated municipal debt which has an average yield of 2.87%. The US Bankruptcy Code denies Puerto Rico public institutions the protections afforded under Chapter 9 and a federal judge recently blocked a law that would allow those public agencies to restructure their debt, ruling it as unconstitutional. A restructuring specialist said that the judge's ruling has deprived Puerto Rico from using its own law and thereby consigned its public agencies to permanent debt peonage and the creditors to a heightened risk of default. (FT)

Afren Plc in talks to recapitalize as Seplat deal fails

Feb 16. London listed oil and gas explorer Afren Plc is discussing with bondholders about the immediate funding and liquidity needs of the firm after the company abandoned takeover plans with Seplat, a Nigerian oil operator. Shares of Afren had been declining as the company was hit by corporate governance scandals, falling oil prices and operational difficulties. Seplat Petroleum proposed to merge the two companies in December but last week, the company said that Seplat's indicative offer was significantly below the aggregate value of the debt of the company. Afren would not be continuing its initial plans with Seplat but would look to other alternative funding channels to help meet its short term liquidity needs. (CityAM)

Dubai World says creditors agree to USD 14.6bn debt deal

Feb 15. Dubai World has received unanimous approval from creditors of its request for a further extension on debt totaling USD 14.6bn. Dubai Worlds' new extension, the second since the financial crisis for Dubai World, calls for early repayment of USD 2.92bn of debt that had been due this year and the extension of the remaining 2018 maturities until 2022. Dubai World plans to repay creditors primarily through asset sales, which have accelerated in recent years. (WSJ)

1MDB settles USD 550mn loan from Malaysian lenders

Feb 13. Malaysian state fund 1MDB avoided default on a USD 550mn loan after it paid back its creditors ahead of its February deadline. The loan was rolled over twice since November and troubles at the state fund had been cited as a negative factor affecting Malaysia's longer term economic outlook. 1MDB planned to list its IPO in November to reduce its debt burden but the IPO filing was delayed several times as the fund had to restructure its loans. (WSJ)

Greek failure to pay official lenders could trigger CDS payment (Reuters)

Indonesia's Bakrie & Brothers in talks for USD 500mn debt-for-equity swap (Reuters)

Brazil's Eneva proposes up to 65% debt haircut in bankruptcy plan (Reuters)

Regulatory Updates

ESMA renews focus on credit rating agencies and trade repositories

Feb 16. The European Securities and Markets Authority has released an annual report detailing its supervisory activities in 2014 and work plans for 2015. ESMA is continuously enhancing its risk-based approach to the supervision of CRAs in order to focus on those risks which have the largest impact on credit ratings. The priorities for this year would be to address the systemic risks posed by CRAs by minimizing the conflicts of interest in the ratings process. In addition, ESMA will continue its investigations into the validation of credit rating methodologies and examine the IT internal controls and information security as well as follow up on the remedial actions relating the issue of structured finance ratings. (ESMA)

BOE says too-big-to-fail reforms should be updated regularly

Feb 13. Financial reforms aimed at putting an end to state bailouts for big lenders should be updated regularly, according to a report published by the Bank of England. Rules could be updated on a regular basis "to keep track of how funding cost advantages change over time" and assess whether they "have been successful or how much more remains to be done," authors Caspar Siegert and Matthew Willison wrote in the report. Policy makers should "keep track of the effect that implicit subsidies have on banks' risk-taking incentives" when assessing the rules, according to the study. (Bloomberg)

New rules on bank capital, swaps clearing set to clash

Feb 12. A new rule requiring banks to hold extra capital against all the assets on their books may have the unintended effect of undermining a central plank of the 2010 Dodd-Frank law. Commodity Futures Trading Commission Chairman Timothy Massad, testifying on Capitol Hill, said he is concerned the rule would make it more expensive for banks to route swaps through clearinghouses, hindering a Dodd-Frank mandate that most swaps be cleared. (WSJ)

IOSCO seeks comment on continuing implementation of PRA principles (IOSCO)

HSBC tax scrutiny flags tax risks for conduct failings (Reuters)

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