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Weekly Credit Brief Jan 19 - Jan 25

Bad loans once again haunt Italian banks

by LEE Yanru

Italian banks had a rocky start to the year as the European Central Bank (ECB) tightened scrutiny over banks' Non-Performing Loans (NPLs), elevating investors' concerns over the asset quality of Italian banks. Bad debts taking a toll on Italian banks are not a recent problem, but more like a ticking time bomb that has been accumulating over the years, and may potentially explode in the near future.

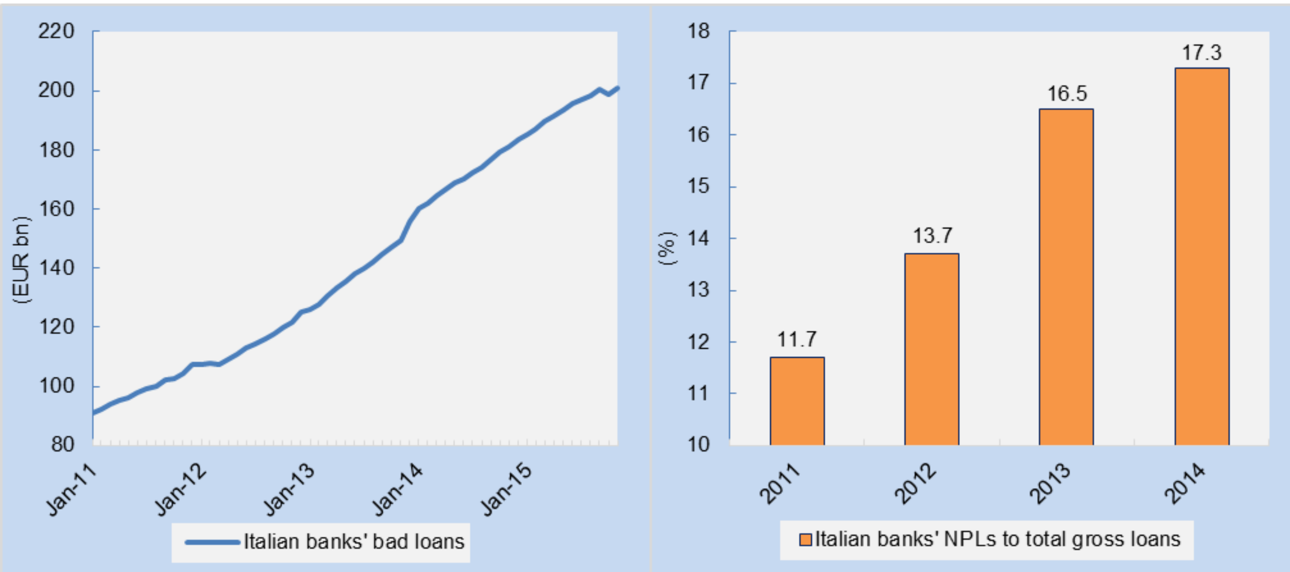

Figure 1: Italian banks' bad loans on the left panel; Italian banks NPLs to total gross loans on the right panel. *Source: Bank of Italy, World Bank*

Italian banks' bad loans, as well as its NPLs to total gross loans have been persistently rising over the years (see Figure 1). Problematic loans, mainly triggered by a sluggish economy, had earlier created a major turmoil in the Italian banking sector before the end of 2014. S&P and Fitch issued negative outlooks and downgraded several major banks, citing rising NPLs as one of the major factors. This concern was temporary suppressed when the ECB launched a government bond-buying program which aimed to stimulate the sluggish Eurozone economy in late January last year. Italian banks reacted positively and the FTSE Italia All-Share Bank index rose about 16.9% between Jan 7, 2015 and Feb 3, 2015. The index continued to increase due to an optimistic economic outlook, as well as the Italian Prime Minister Matteo Renzi's commitment to mitigate the Italian banks' NPLs.

Recently, NPLs in Italian banks once again have taken the spotlight after investigations by the ECB. The FTSE Italia All-Share Bank index plummeted by nearly 9% last week, resulting in trading suspensions of the shares of several Italian banks. The Italian market regulator Consob had to step in to introduce temporary short selling bans in shares of Banca Monte Dei Paschi di Siena S.p.A (Monte dei Paschi) after the lender incurred a significant reduction in its market cap.

Moreover, retail financing to Italian banks has collapsed by EUR 75bn in the 12 months ending Sep 2015, as four bank failures and investment losses have made the public more mindful of the heightened credit risk of bank notes. The loss in capital availability means that lenders will have to turn to more expensive sources of funding such as wholesale financing. Based on the Bank of Italy's data release last Monday, retail holdings of the notes have decreased by 27% to EUR 200bn since its peak in 2012.

The aggregate RMI-CRI 1-year Probability of Default (PD), a simple median for the top 10 Italian banks in terms of revenue, has risen substantially from 22.3bps at the start of the year to its recent high of 36.4bps on Jan 20, coinciding with the decline in the FTSE Italia All-Share Banks Index. Subsequently, the aggregate RMI-CRI 1-year PD declined slightly when Prime Minister Renzi tried to restore the confidence in the Italian banking sector, by claiming to "work miracles" with his economics minister in solving Italian banks' bad loans problems (see Figure 2).

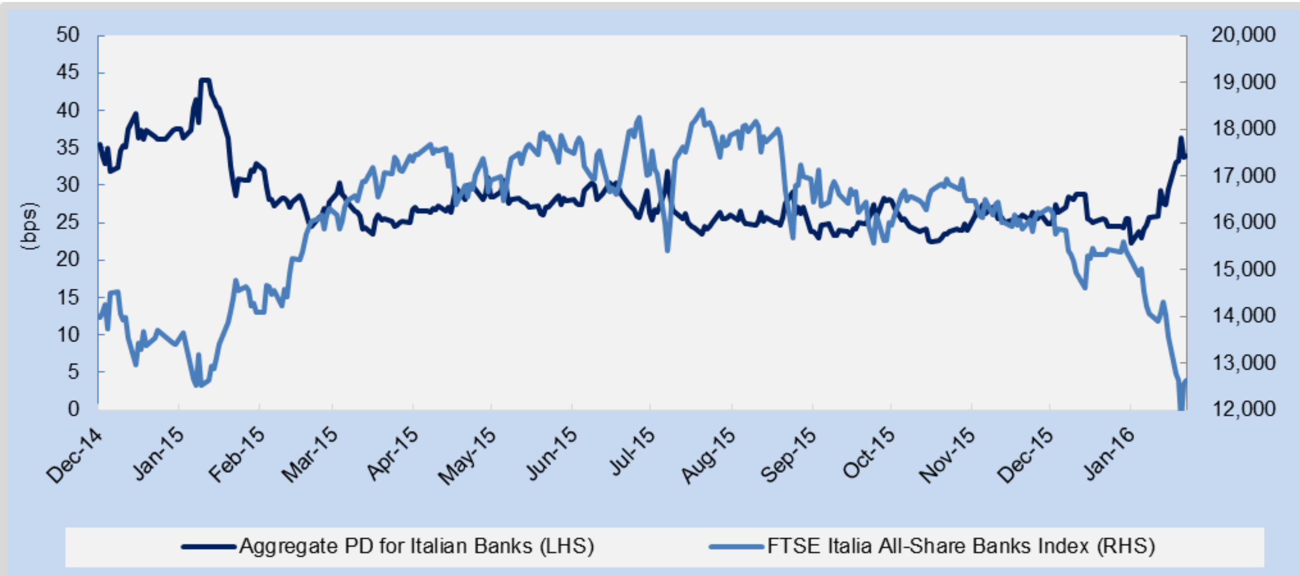

Figure 2: RMI-CRI 1-year aggregate Probability of Default (PD) for top 10 Italian Banks (by revenues) and FTSE Italia All-Share Banks Index. *Source: RMI-CRI, Bloomberg*

From a firm-specific perspective, the financial statements of several major Italian banks also highlight some financial difficulties (see Table 1). Intesa Sanpaolo, Unione di Banche Italine (Ubi Banca) and Banco Popolare dell'Emilia Romagna (Popolare Emilia) all reflect low or declining net interest margin (NIM), highlighting lower profitability during 2015. Additionally, the banks' ratios of non-performing assets (NPA) to total assets have been increasing, as a result of deteriorating loan quality on their balance sheets.

	Intesa Sanpaolo			**Ubi Banca**			**Popolare Emilia**		
	Q1 2015	Q2 2015	Q3 2015	Q1 2015	Q2 2015	Q3 2015	Q1 2015	Q2 2015	Q3 2015
Net Interest Margin (%)	1.27	1.27	1.22	1.54	1.51	1.50	2.12	2.07	2.05
NPA / Assets (%)	9.30	9.54	9.65	11.03	10.87	11.80	18.42	18.43	18.77

Table 1: Financial data for selected Italian banks. *Source: Bloomberg*

Presently, Prime Minister Renzi has asserted his commitment towards reducing bad loans in Italian banks. However, this scenario resembles last year's event as bad loans continue to rise, despite similar assertions made by Renzi back then. Will history repeat itself as more Italian banks start to fall apart, just like four of the Italian banks in December last year? Or will this time around, Italy finally come up with an appropriate solution to mitigate its banking industry's problematic loans for the long term?

Credit News

US junk-rated energy debt hits two-decade low

Jan 24. The value of debt issued by junk-rated US energy companies has plummeted to the lowest level for more than two decades, sending a warning signal about the outlook for the North American oil industry. The slump in bond prices took a further step down last week, as crude dropped to 12-year lows below USD 28 per barrel. Very few US shale oil developments can be profitable with crude at about USD 30 per barrel. More than half of the junk-rated energy groups in the US have fallen into distressed territory, where bond yields have risen more than 1,000 basis points above their benchmark Treasury counterpart. (FT)

EM borrowing costs rise as credit fears grow

Jan 20. Emerging market borrowing costs hit their highest level in five years on Wednesday with investors warning that the developing world faces a debilitating credit crunch. Selling pressure is being fanned by weakening local currencies, leaving borrowers of dollar-denominated debt, including Brazil and South Africa, facing sharply higher interest costs. Average government borrowing costs in dollars have reached 6.7%, up from 5.3% last year, while the risk premium between EM bonds and US Treasury yields has breached levels that were reached during times of market turmoil including the taper tantrum and Eurozone crisis. (FT)

Oil rout raises fears of Venezuela debt default

Jan 20. Slumping crude prices have investors bracing for a messy default in Venezuela, where the sovereign and state-owned oil company PDVSA have some USD 10bn in external debt payments due this year. With crude hovering around USD 28 per barrel, Venezuela - which on Wednesday reportedly requested an emergency OPEC meeting - could have trouble satisfying its obligations. According to Barclays, the country will have difficulty avoiding a credit event in 2016 - and that is based on the bank's forecast of USD 37 oil, almost USD 10 higher than current prices. (Reuters)

World faces wave of epic debt defaults, fears central bank veteran

Jan 19. The global financial system has become dangerously unstable and faces an avalanche of bankruptcies, a leading monetary theorist has warned. Debts have continued to build up over the last eight years and they have reached such levels in every part of the world that they have become a potent cause for mischief, according to the Swiss-based chairman of the OECD's review committee. The next task awaiting the global authorities is how to manage debt write-offs without setting off a political storm. European banks are heavily exposed to emerging markets and are almost certainly rolling over further bad debts that have never been disclosed. (The Telegraph)

Canada grapples with housing bubble risk

Jan 19. The housing-price index of the Canadian Real Estate Association rose by nearly 19% year-on-year in December 2015. In certain segments, the benchmark price has more than doubled since 2005. The government is expected to introduce further cooling measures in its February 2016 budget. It has, so far, tightened mortgage rules in December 2015 and increased the banks' capital requirements to protect against residential mortgage risk. (WSJ)

Mercator Lines placed under judicial management (Seatrade)

Charges to send Deutsche to EUR 6.7bn loss (FT)

Indian regulators working on solution to bank NPAs (Economic Times)

Regulatory Updates

IMF scraps loophole allowing bigger loans to stop contagion

Jan 21. The International Monetary Fund (IMF)'s executive board has voted to drop a systemic exemption, which was created in 2010 to allow loans above its lending limit when Greece's default threatened a global spillover. The IMF has said that it would not provide a fresh loan to the country when the current loan program expires in March 2016, until European governments provide debt relief and there is further progress from Greece on economic reforms. (Bloomberg)

Basel rules to cost banks up to EUR 120mn each

Jan 19. A new study from consultants Oliver Wyman estimated that global banks will require expenditure of between EUR 40mn to EUR 120mn each to implement the latest rules finalized by the Basel Committee this month. While the final draft turned out to be less restrictive than earlier versions, regulators expect the rules to increase capital requirements by 22% on average. (FT)

ECB lowers ELA cap for Greek banks (Reuters)

EU laws debate writing down bank creditors (Bloomberg)

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