



British exit looms over European banking sector

by [Justin Hsiao](#)

The United Kingdom (UK)'s decision to leave the European Union (EU) has taken a great toll on both sides of the North Sea, especially on the banking sector. Major European lenders have seen their shares losing a third of their value since June 23. The Stoxx Europe 600 Banks Index, a capitalization-weighted European banking index, was close to its 2011 debt crisis low last week (see left panel in Figure 1). Most of the share prices of European lenders – Deutsche Bank AG, Credit Suisse Group AG, Banco Popular Espanol SA, UniCredit and Banca Monte dei Paschi di Siena Spa – reached fresh all-time lows. The market is worried that the British divorce will ignite the risk of recession in the regional economy and shake the continent's already-fragile banking system.

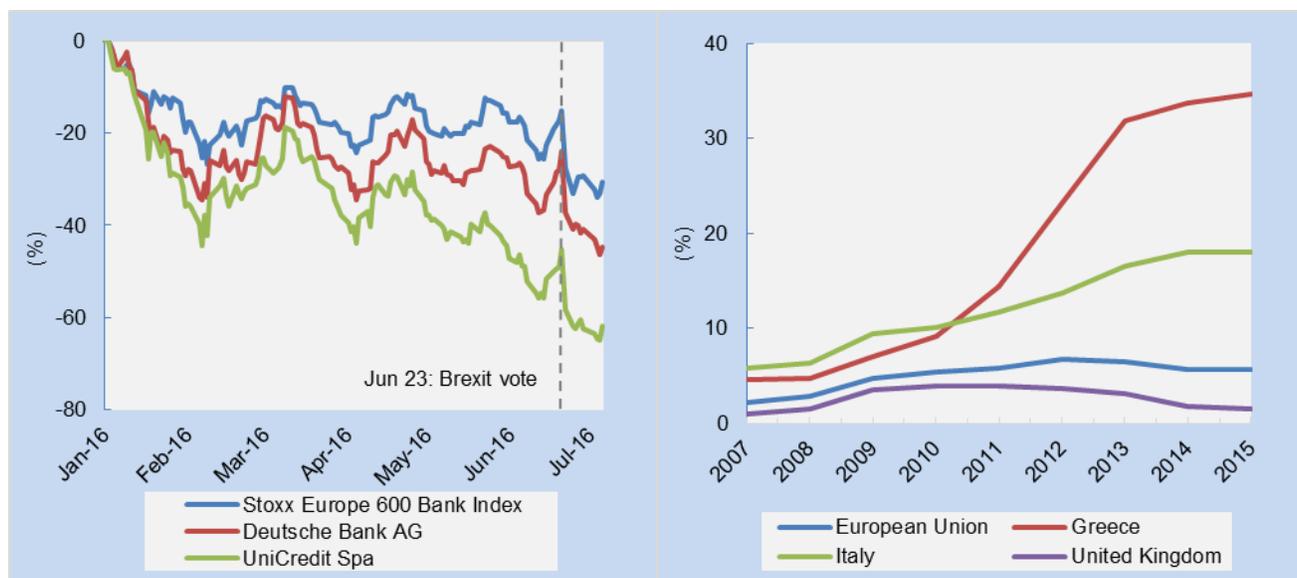


Figure 1. Share performance of the European bank index, the largest regional bank and the largest Italian bank (left panel); Non-performing loans to total gross loans ratio for European banks (right panel). *Source: Bloomberg, World Bank*

After Brexit, the International Monetary Fund [downgraded](#) its projections for growth in the euro area, from a growth of 1.7% in both 2016 and 2017 to a growth of 1.6% this year and 1.4% next year. It is highly expected that the central banks will keep interest rates lower for longer in order to counteract slower growth – both in the Eurozone and Britain. The European Central Bank (ECB) has already set the benchmark rate at 0% this year, and the Bank of England is considering a [rate cut](#) this week. European banks have been uneasy over the concerns that prolonged low interest rates will cut into their profit margin from lending. This is especially painful to some smaller regional banks, as most of their businesses are plain-vanilla lending activities, with limited fee-generating activities such as asset management and investment banking.

The asset quality of European lenders was also a key trigger of this banking shares selloff. The [Italian banks' bad loans](#) were in the spotlight. Italian banks had nearly 17% non-performing loans (NPL) in 2015 (see right panel in Figure 1). During the 2008-09 financial crisis, the NPL ratio for American banks was only [5%](#). Brexit could worsen this problem as an economic slowdown usually makes bad loans pile up further. The Italian government has been in talk with Brussels to devise a plan to recapitalize its banks. However, such a plan will violate the anti-bailout rules adopted by EU in 2014. Some people believe that a banking crisis in EU's third largest economy will [spread](#) to the rest of the Europe.

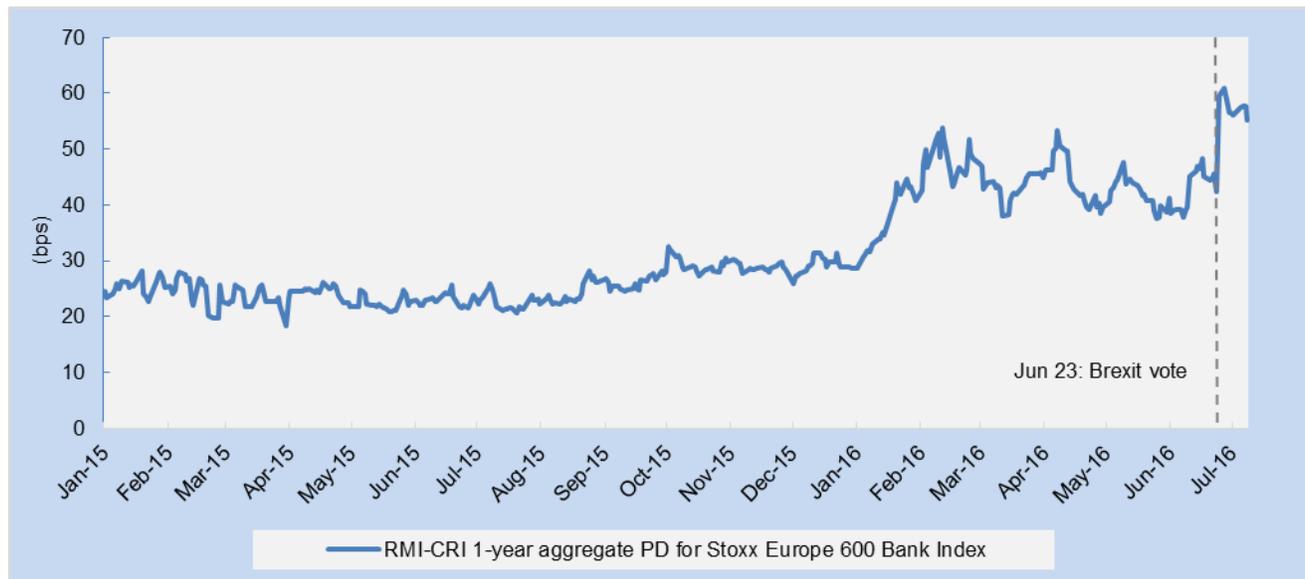


Figure 2. RMI-CRI 1-year aggregate PD for 48 banks in the Stoxx Europe 600 Bank Index. Source: RMI-CRI

The RMI-CRI 1-year Aggregate Probability of Default (PD) for banks in the Stoxx Europe 600 Bank Index became quite volatile this year and started to increase from 30bps at the beginning of 2016 to almost 60bps now, indicating an unstable and deteriorating credit health for the European banking sector (see Figure 2).

Table 1 demonstrates the credit metrics of the EU banks. The Common equity tier 1 (CET1) capital ratio, a measure of a bank’s core equity capital compared to its total risk-weighted assets, slightly declined in the first quarter of 2016, driven by a decline in capital. The net interest margin dropped from 1.60% in Q4 2015 to 1.50% in Q1 2016, in line with lower interest rates. European banks have long been criticized for having redundant staff and low efficiency, resulting in higher cost. The cost to net operating income ratio increased from 59.3% in Q2 2015 to 66.0% in Q1 2016.

	Q2 2015	Q3 2015	Q4 2015	Q1 2016
CET1 Ratio (%)	12.5	13.0	13.6	13.4
Net Interest Margin (%)	1.58	1.58	1.60	1.50
Cost to Net Operating Income Ratio (%)	59.3	60.0	62.8	66.0

Table 1. Credit metrics of European banks. Source: European Banking Authority

Brexit has not only shaken up the European political landscape but also highlighted the financial vulnerability in the region. EU must better manage its financial sector under a single currency system going forward. Meanwhile, Italy will also have a referendum on constitutional reforms in October. In 2017, the Netherlands, France and Germany are going to have their general elections. Any outcome that favors anti-EU political parties would be likely to rattle the market again. The credit profile of the European banking sector remains highly uncertain post-Brexit.

Credit News**Soaring healthcare costs force Chinese into crippling debt**

Jul 11. Boston Consulting Group estimated that China's personal healthcare costs will increase nearly fourfold to CNY 12.7tn by 2025, as more people borrow money to pay for their medical costs. Consumer borrowings have tripled in value since 2010 to nearly CNY 21tn and the debt situation is likely to worsen. The Chinese government is struggling to keep healthcare affordable and improve basic insurance coverage. Poorer residents living in rural areas who are unable to keep up with the rising healthcare costs, have pawned their personal belongings for cash. The growing need for healthcare has attracted companies such as Ping An Insurance Group and other P2P firms to the sector as loan demand continues to grow. ([Straits Times](#))

Deposit decline begins to hurt Saudi banking sector liquidity

Jul 10. Saudi banks are likely to face a further squeeze on liquidity in light of the sustained decline in bank deposits. The decline is attributed to a decline in economic growth and fiscal adjustments necessitated by a persistent slump in oil prices. According to Moody's, the declines in deposits are credit negative as they add pressure to the bank's liquidity while loan growth has remained above 9% since January. Dubai-based Arqaam Capital attributed the tightening liquidity to the government's withdrawal of deposits and sales of local currency debt. The central bank has attempted to ease the cost pressure by increasing the maximum loan-to-deposit guidance to 90% from 85%. ([Gulf News](#))

Mongolian Mining seeks debt moratorium as it outlines winding up plans

Jul 8. Mongolian Mining Corporation (MMC) sought a debt moratorium amid a winding up petition filed on July 7 by the company to facilitate its debt restructuring after it failed to service a USD 200mn facility and missed the semi-annual interest payment on its USD 600mn notes. At the end of 2015, MMC reported USD 50.7mn cash and almost USD 795.2mn debts. The company proposed issuing USD 420mn of six-year bonds with coupons pegged to future coal prices, which was done to reduce MMC's pressure to service debt when coal prices are low, USD 150mn of perpetual notes with variable coupons and USD 1.03bn worth of new shares to repay creditors. ([Bloomberg](#))

Postmedia reduces debt load by USD 300mn by turning debt holders into shareholders

Jul 7. Postmedia reached an agreement with its bondholders and shareholders that its lenders will become the majority owners of the company, wiping out USD 307mn worth of debt in the process. The bondholders will get 98% of the company's equity, leaving the existing shareholders with only 2% of the equity. Postmedia's share price has dropped significantly from a high of USD 15 per share five years ago to only USD 0.015 per share on Thursday. The conversion of debt to equity allows the company to shore up its balance sheet by cutting a significant portion of its debt. ([CBC](#))

Three more UK property funds halt investor redemptions

Jul 6. Following the Brexit vote, three more fund managers have stopped investors from withdrawing from their UK property funds, bringing the total number of funds that are unable to meet withdrawal requests to six. With over half of the GBP 25bn of funds committed to commercial property under lockdown, asset managers are hard-pressed to sell buildings in order to raise cash. In response to the fund 'gatings' spreading panic on the broader market, the Bank of England warned that this would amplify the downswing in commercial real estate. ([FT](#))

S&P turns negative on Australia outlook ([FT](#))

S&P sounds alarm on hedge fund reinsurers ([FT](#))

Indian banks need USD 90bn to meet Basel III rules, Fitch says ([The Times of India](#))

Regulatory Updates**China's insurance regulator eyes tighter scrutiny on 'too big to fail' players**

Jul 10. China is expected to identify a list of domestic, systematically important insurers for tighter regulatory oversight to ensure the stability of its financial services sector. The companies, which will be determined by the China Insurance Regulatory Commission, are expected to be subjected to additional recovery and resolution planning requirements, in addition to tighter capital controls and enhanced group-wide supervision. While the stricter regulations have stirred discontent among big insurers, law practitioners in the industry believe that the affected insurers may be compensated with some concessions by the regulator. ([SCMP](#))

Bankruptcy legislation for big banks gains steam

Jul 7. The House of Representatives has passed, by voice vote, the proposal to effect changes to the bankruptcy code, which is included in the financial-services budget bill. The proposed Financial Institutions Bankruptcy Act would establish a section of the bankruptcy code specifically for large financial firms to prevent a repeat of the 2008 Lehman Brothers collapse. The amendment, which passed the House Judiciary Committee unanimously previously, is included in the budget bill to increase its likelihood in clearing the Congress this year, given that lawmakers are less likely to pass new legislations in an election year. ([WSJ](#))

FCA to probe peer-to-peer lending sector ([FT](#))

Canada's top banking regulator tightens scrutiny of mortgage lending practices amid soaring home prices ([Financial Post](#))

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