



Credit health of US banks remains robust despite ongoing macroeconomic headwinds

by [Lee Wei Qi](#)

- **Recent earnings revealed revenue slowdown dragged by deal-making and mortgage origination**
- **As corroborated by CriAT's iRAP, the sector remains fundamentally robust on the back of NIM expansion and strong capitalization**

Earlier this month, multiple US banks released their Q2-2022 earnings which revealed possible macroeconomic downsides that may have impacted the industry's credit health. In [Jun-2021](#), NUS-CRI found that the aggregate credit health of US-domiciled banks had been improving on the back of improved liquidity and profitability. Since then, the macroeconomic tides have turned. Jun-2022 US CPI numbers revealed a 9.1% YoY increase, the largest jump since 1981. The street now notes that a [recession has been priced into bonds](#) while the [stock markets have accounted for stagnating growth](#). With the looming risks of inflation and a potential recession, it is imperative to reexamine the conduits of effective monetary transmission of the world's largest economy. Referencing the NUS-CRI Aggregate 1-year Probability of Default (Agg PD) in Figure 1, divergence can be noted since Jan-2022 as the 75th percentile increasingly deviated upwards while the median and the 25th percentile remain relatively stable.

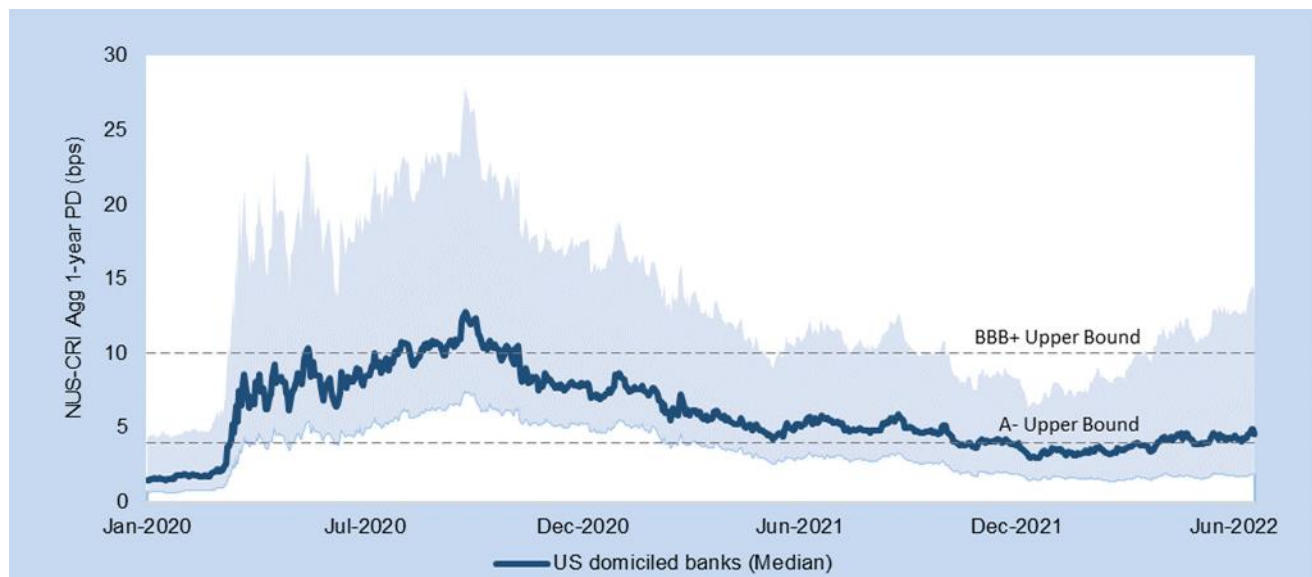


Figure 1: NUS-CRI Agg (median) 1-year PD for US banks from Jan-2020 to Jul-2022 with the interquartile range of the industry, with reference to PDiR2.0 bounds¹. *Source: NUS-CRI*

The recent earnings season has shed some light on the current challenges faced by the US banking industry and may provide insights on future headwinds. Against the backdrop of global supply chain issues, China's tango with its reopening policy, and the impact of geopolitical tensions between Russia and Ukraine on the global markets, aggressive monetary policy tightening adds to what seemed to be an already stressed macro environment. With a distressed economic outlook, US banks' investment banking revenue has seen its first hit. Subdued revenue from [deal-making posted a drag on earnings](#). Beyond the [slowdown in IPOs](#), investment banks are taking losses on corporate bond deals as investors demand higher yields and greater discounts. Poorer expectations have also led to the banks taking on [cost-cutting measures](#) while [increasing allowances for credit losses](#). Moreover, the increasing interest rate environment has dragged [mortgage originations](#). According to the Mortgage Bankers Association, mortgage demand has hit [the lowest point since 2000](#). While [consumer spending](#)

¹ The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation through mapping the NUS-CRI 1-year PDs to the S&P letter grades. The method targets S&P's historical credit rating migration experience exhibited by its global corporate rating pool instead of relying solely on the reported default rates.

[remained relatively robust](#) this earning season, a slowdown could be due should the economy teeter into a recession.

After a GDP decline of [1.6%](#) in Q1 2022, a second consecutive quarter of negative GDP growth could drag sentiments further. Nevertheless, with Q2 2022 numbers due on Jul 28, 2022, the industry, as well as the [US government](#), remains upbeat with [consensus estimates at a gain of 1%](#) as the US labor market remains robust, consumers are flushed with cash while manufacturing is still expanding. These silver linings could account for why US banks' [non-performing loans have remained subdued](#). Ahead of the Fed's July policy meeting, Powell has expressed that the central bank will likely further raise interest rates [by 50 or 75 bps](#). Increasingly so, market participants are expecting the Fed to abandon its monetary policy guidance for another month, with the futures market [increasingly leaning](#) towards a 100 bps hike. Following rampant inflation levels, the central bank has reiterated its [unconditional commitment](#) to bring down prices. Higher interest rates benefit banks' earnings as bank assets generally reprice faster than liabilities which lifts net interest income.

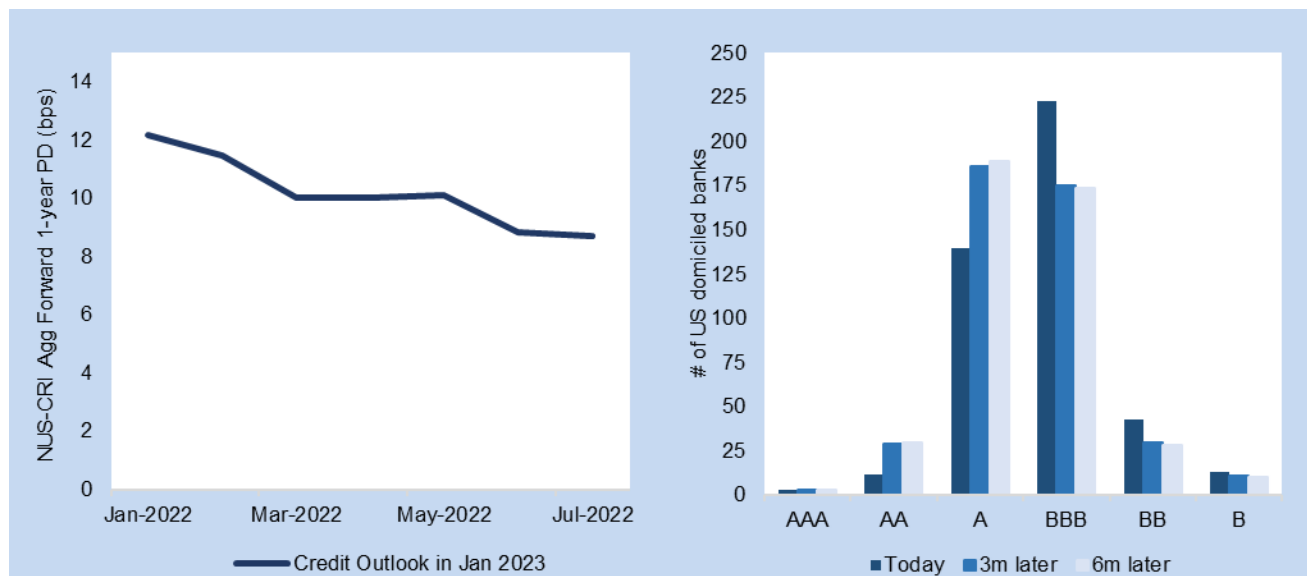


Figure 2a (LHS): NUS-CRI Agg Forward 1-year PD time series for US banks based on information from different historical months. Figure 2b (RHS): Present and forecasted credit distributions of the US banking industry, with reference to PDI2.0 bounds. *Source: NUS-CRI, CriAT*

Beyond subdued NPL levels and NIM expansion, the US banking system has come [a long way in terms of its capitalization](#). As of Jun-2022, the Fed found that the large banks can [weather more than USD 600bn in losses](#) while maintaining lending to the US economy. In addition, for systemically important banks that may have higher exposure to global macroeconomic headwinds, the Fed has imposed [an additional surcharge on their CET1](#) requirement of 50bps in 2023. The measure ensures that banks maintain adequate capital buffers in case of a drastic downturn, and potentially bode well for maintaining wider stability in the financial network. Where financing is concerned, the banks are [ahead of their financing schedule](#). There seem to be [limited supply needs](#) as bank bond sales for both May and June followed historical averages when spreads were tighter. The aforementioned factors could account for the downward trend suggested by the NUS-CRI Aggregate (Median) Forward 1-year Probability of Default (Forward PD²) time series in Figure 2a, with the industry's credit risk outlook for the next six months set to improve. Moreover, it is noteworthy that, using CriAT's iRAP³ tool, more than 85% of US banks are and will remain investment grade over the next six months (See Figure 2b).

The 75bps rate hike due in Jul-2022 marks one of the fastest hikes to the target range of 2.25% to 2.50% - a [widely deemed "neutral" level](#) where monetary policy is no longer supporting the economy in the long run. With that benchmark in sight, the debate between inflation and economic growth could be renewed over time. Currently, with inflation breaking all-time highs despite policy actions taken by the Fed, policymakers have maintained a united front to raise rates unconditionally. The unknown lies in how monetary policy will be once inflation shows signs of easing. Should inflation ease over time, the hawkish or dovish tilt guided by policymakers would materially affect the credit risk outlook of US banks.

² The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similarly to a forward interest rate. For example, the 6-month Forward 1-year PD is the probability that the firm defaults during the period from 6 months onwards to 18 months – this is conditional on the firm's survival in the next 6 months.

³ iRAP (intelligent Risk Analysis Platform) is a software developed by CriAT (<https://www.criat.sg/>) for conducting both firm-level and portfolio-level credit analysis. iRAP utilizes the NUS-CRI Probability of Default (PD) model and links it to the live NUS-CRI database offering PDs on almost 80,000 exchange-listed corporates globally.

Credit News

China's credit market rocked by more debt delays, plunging bonds

Jul 21. With China's junk bonds close to creating record lows, China's credit markets indicate a worsening situation as the property crisis deters investors. With instances of delayed payments on the rise, creditors have also taken a tougher stance as they push back on unfavorable restructuring plans. The increased stress in China's credit markets also indicates a lack of confidence in the government's ability to bring about an economic turnaround. To allay fears, the banking and insurance authority of the country reiterated that they will support the government's efforts in delivering property projects. ([BT](#))

Canadian banks hoard cash with record ultra-safe bonds abroad

Jul 22. The Bank of Canada has, so far, raised its benchmark rate to 2.5%, the highest since 2008. With the expectation that rates will continue increasing to control consumer price inflation, which is currently at its highest level since 1983, banks are strengthening their liquidity position to cushion against higher-than-usual deposit outflows induced by declining disposable income. To do so, they are ramping up the sale of secured debt, a cheaper financing option than unsecured debt. Recently secured debt deals were quoted at a yield spread of around 70bps over Canadian government bonds, in contrast to similar maturity unsecured debt's yield spread of 126bps. ([Bloomberg](#))

Debt losses for buyouts top USD 1bn and banks brace for more

Jul 20. US banks have suffered costs of at least USD 1.3bn as the economy rolls into a fear of recession pushing investor demand for risky debt lower. The losses are majorly due to LBO and loan commitments before the worsening of the credit markets took hold. Furthermore, loan prices have taken a steep fall as banks try to offload their loans before any further worsening, cuts into their margins. The banks expect additional losses in the upcoming months as around USD 38.1bn of committed loan financing is yet to be sold to investors, along with USD 31.3bn of junk bond funding. ([BT](#))

Banks are flooding the US market with bonds many hadn't expected

Jul 21. Wall Street banks have stepped up borrowing from bond markets this year, with banks accounting for 55% of the USD 427.7 bn raised by financial companies in 2022. Expectations of higher interest rates as the Fed commits to further tightening are driving the increased borrowing. Additionally, increased regulations post the 2008 financial crisis also push the banks to maintain sufficiently high liquidity. The market expects balance sheet trends to drive issuance decisions in the next half of 2022. ([Bloomberg](#))

Clock ticks for Evergrande restructuring plan after shakeup

Jul 24. Evergrande is set to announce a preliminary restructuring proposal for its USD 300bn debt by the end of July. Such a proposal is expected to unveil the nature and magnitude of the government's intervention in handling such a crisis, especially on the treatment of offshore debt, and may become a precedent for other troubled developers. Earlier, Evergrande's CEO and CFO were forced to resign amid an internal investigation on the use of deposits as collateral for pledge guarantees, which eventually added to the company's cash crunch. With majority of defaulted real estate developers yet to present restructuring plans, the market is expected to scrutinize Evergrande's announcement. ([Bloomberg](#))

Warnings of sovereign defaults in Asia frontier markets flare up ([Bloomberg](#))

UK debt interest payments jump to all-time high ([FT](#))

Euro zone bond yields tumble as contracting business activity fuels recession fears ([FP](#))

Regulatory Updates

ECB raises rates for first time in more than a decade

Jul 21. The ECB has hiked the interest rate by 50bps, moving the rate above zero for the first time in nearly a decade. The move comes as a response to surging inflation hitting 8.6% in June. However, this especially endangers Italy, which has witnessed a massive bond selloff over fears regarding the sustainability of its large public debt and political woes following the resignation of Mario Draghi. Unabating price pressures could result in a further rise in rates by the ECB, pushing the bloc closer to a recession. ([FT](#))

Japan defies wave of inflation-fighting hikes by keeping rates at rock bottom

Jul 21. The Bank of Japan (BOJ) is one of the last central banks in the developed markets to tighten its monetary policy, with a rock-bottom interest rate potentially weakening the Japanese yen. With concerns rising regarding the impact of heightened tightening measures impacting growth prospects, markets are punishing yen-denominated securities less harshly, with only a few speculative bets against Japanese bonds. However, if the expectations of an upcoming recession soften, the yen and yen-denominated securities could be further penalized. Adding further fuel to the fire is the uncertainty regarding policy movements, as the BOJ's latest expectations of price growth are larger than their previous projections, which could turn to monetary tightening if inflation risks run rampant. ([Bloomberg](#))

Australia central bank says rates still too low to contain inflation ([CNBC](#))

Russia slashes key interest rate by 150 basis points in shock move ([CNBC](#))

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