Weekly Credit Brief

Jul 23 - Jul 29 2013

Story of the Week

HKMA enhances CNY liquidity windows, a credit positive for smaller lenders

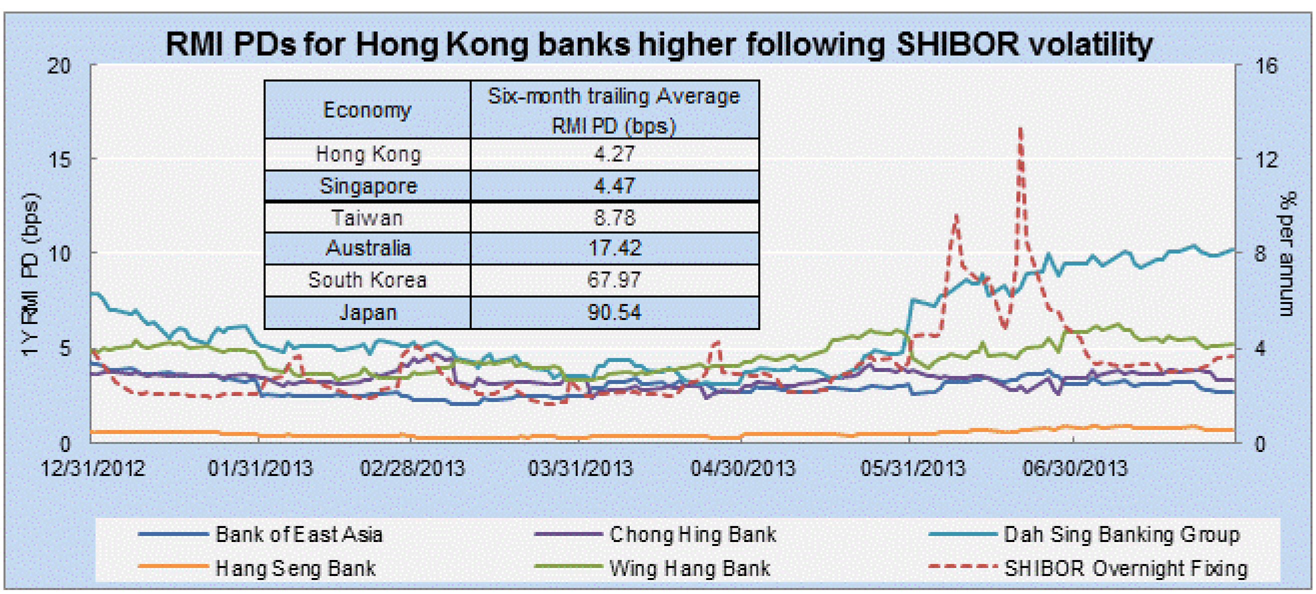
By James Weston

Last week, the Hong Kong Monetary Authority (HKMA) announced two enhancements to its CNY liquidity window for banks participating in the offshore CNY trade. From July 26, the HKMA began offering one-day funds for delivery the following day, using its CNY 400bn Swap Agreement with the People's Bank of China (PBOC). This supports a one-week facility it has offered since mid-2013 using the same swap line, which is said to be unpopular with local banks due to its longer-tenor and high borrowing rates. In addition, the HKMA will offer up to CNY 10bn of overnight funds, available on the same business day, to help banks meet liquidity needs, using its own sources of funding from the offshore markets.

The move is aimed at preventing future liquidity crises on the Chinese mainland spreading to the city state's banking system. In late-June, short-dated Shanghai interbank offered rates (SHIBOR) soared when the PBOC refrained from adding fresh liquidity to the mainland banking system. Chinese bank subsidiaries sent CNY funds back to the mainland, which helped spread liquidity stress to offshore markets, where CNY interbank rates also rose. Banks in Hong Kong raised deposit rates in an attempt to secure fresh CNY funds. Some market participants were forced to sell their holdings of "dim sum" bonds, CNY-denominated bonds issued in Hong Kong, in order to raise sufficient funding, causing average yields on such bonds to increase from 4.35% in May to as high as 5.85% in June.

The liquidity window enhancements are credit positive for small and medium sized banks in Hong Kong, who lack the large scale CNY-denominated deposits of large Chinese banks, and trade settlement banks such as HSBC. Because of this, smaller banks are dependent on CNY interbank markets in Hong Kong for liquidity. The enhancements to the liquidity facility provide such lenders with an alternative channel to access CNY liquidity in times of stress.

The RMI probability of default (RMI PD) model currently produces RMI PDs for five medium sized lenders in Hong Kong who participate in the offshore CNY market, as shown in the chart below. The individual RMI PDs have trended upwards since June, when interbank rates in mainland China increased dramatically, illustrating how liquidity stresses in the mainland can affect smaller lenders in Hong Kong. The HKMA's enhanced liquidity window should help offset this risk going forward. Moreover, Hong Kong banks continue to have the highest credit quality among banks in developed Asia-Pacific.

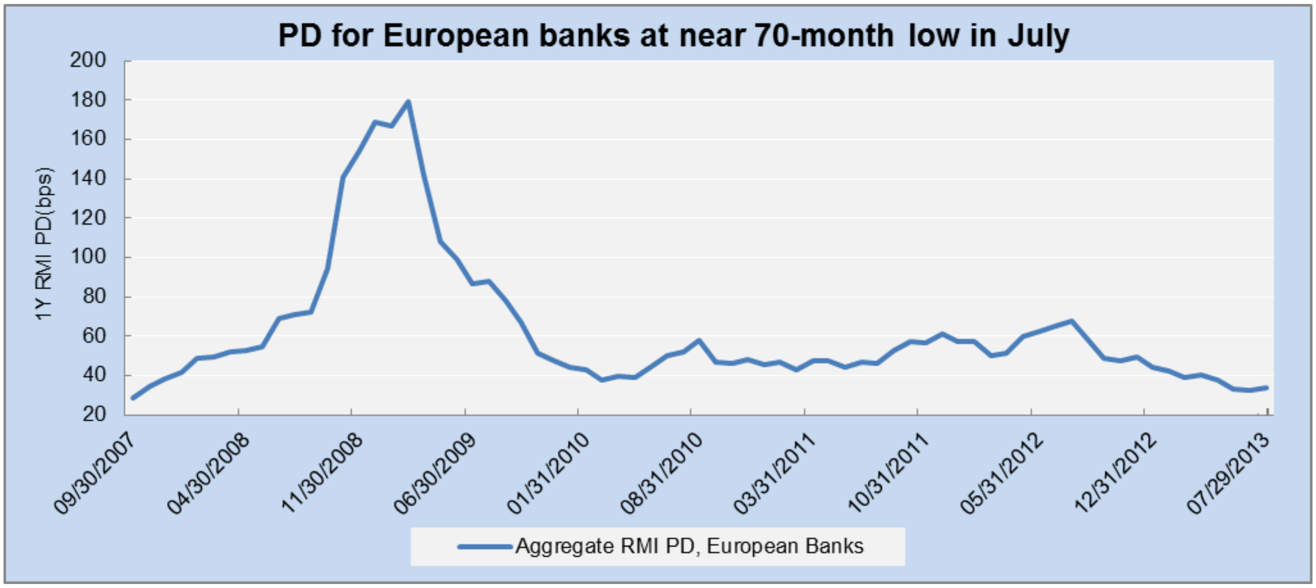


Sources:
Refinements to the CNY Liquidity Facility (HKMA)
Hong Kong boosts CNY liquidity to ease credit crunch (FT)
Hong Kong enhances liquidity windows for offshore CNY (Reuters)

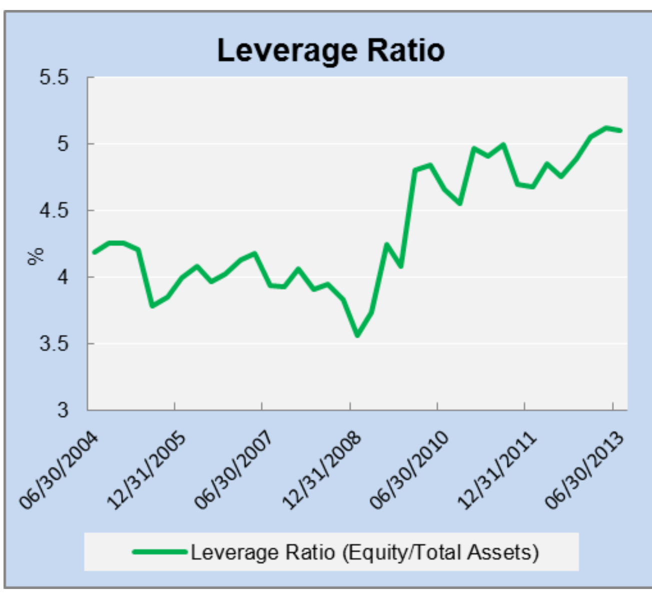
Chart of the Week

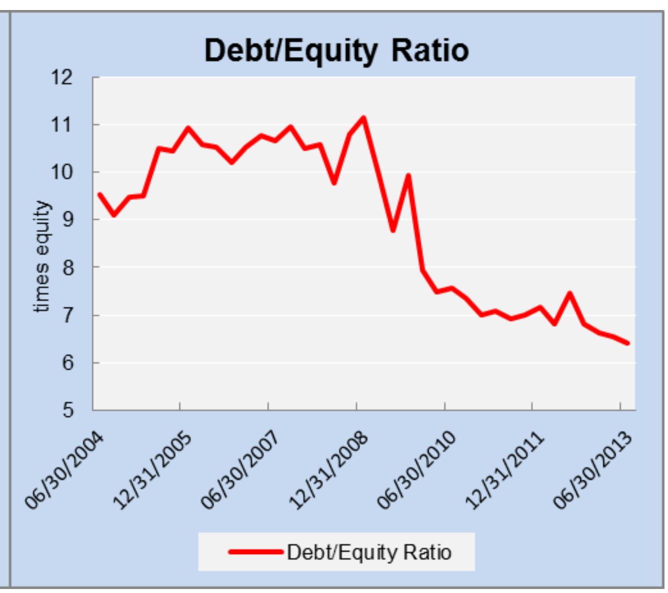
RMI PD for European banks at a six-year low

By Jonathan Jun Jie Ne Win



The credit outlook for European banks has improved materially, with the RMI probability of default (RMI PD) for European banks falling to a 70-month low in June, before increasing slightly through July. This came as a result of massive increases in capital by Europe's biggest banks. Under current Basel leverage proposals, banks would have to hold equity equal to 3% of total assets by 2018. However, many European banks, anticipating tougher regulation, more than doubled their equity to USD 1tn since 2007. For instance, Barclays announced to raise USD 12bn in new capital on July 30.





Using data from the Bloomberg Europe Banks and Financials Index[1] as a proxy for European banks, we observe that the leverage ratio (equity divided by total assets) has reached a ten-year high of 5.1% of total assets while the debt/equity ratio has fallen to a ten-year low of 6.42 times equity. An increase in equity and reduction in debt translates to a higher distance-to default (DTD), or volatility adjusted leverage. DTD is a key

[1] A market cap-weighted index that includes the 500 largest banks and financial companies in Europe

factor in the RMI PD model. Thus, the fall in the debt/equity ratio has resulted in a lower default risk for the sector. Despite these positive developments, many are concerned that the new bank regulations and more stringent capital requirements are likely to hamstring future growth. As such, the credit outlook for European banks remains a little unclear.

Sources

Europe banks get set for dividend lift - if regulators allow (Reuters)
European banks face capital gap with focus on leverage (Bloomberg)
Barclays to raise USD 12bn in new capital (The New York Times)

In the News

Junk Bond Fever Building as High Grade Trails

Jul 29. Funds which invest in speculative-grade bonds received a record USD 5.4bn in deposits in the weeks ended July 24, at the same time investors withdrew USD 1.8bn from investment-grade funds, according to data from EPFR Global. Investors who withdrew money from junk bonds en masse in late-June are now casting aside concern the securities will lose their allure as the US Federal Reserve slows its record stimulus, due to the extra yield speculative-grade securities offer. This demand is allowing the neediest borrowers to increase their indebtedness further. (Bloomberg)

MYR touches 5-Week low on speculation China growth to weaken

Jul 29. The MYR declined to a five-week low on poor trade outlook, following the latest results of China's Purchasing Manger's Index. The monthly poll of business conditions in Malaysia's second largest export market reported the poorest numbers in 10 months, worsening the outlook for Malaysian exports which have already shrunk year-on-year for four consecutive months ending May. Consequently, the ringgit depreciated 30bps to 3.2171 per USD while the yield on the 3.26% 5-year government bonds rose 1bps to 3.63%. (Bloomberg)

Korea to ease taxes to boost investment

Jul 28. Korea's Ministry of Finance announced that taxes on transaction between parent companies and their subsidiaries or affiliates would be lowered in a bid to boost the economy through investments but regulatory rates of ownership in units and sales exceeding 40 to 50% of the total transactions may rise to 5 to 10 % equity ownership in unit and sales. In addition, the Finance Ministry is considering extending the tax deduction benefits on credit card spending by workers on average salaries until next year. However, tax deductible rate of credit card spending may be lowered from 15 to 10%.Through such measures that aim to improve business investment, the ministry hopes to revive the economy in the second part of the year. (The Korea Herald)

CNY 1tn fled China banks. you won't believe where it went

Jul 28. China's Big Four banks saw CNY 1tn of deposit outflows in the first three weeks of July, with CNY 700bn leaving in the first week alone. Quarter-end borrowings that increase reported cash to meet a strict loan-to-deposit ratio mandated by the central bank, combined with wealth management products designed to mature before the end of the quarter, are believed to push up deposits reported on bank balance sheets. The deposits then flow out of banks at the end of the quarter; creating concern banks do not have sufficient deposit bases to conduct safe business. In addition, research by Fitch ratings shows Chinese money-market funds lost about 45% of their assets in the second quarter of 2013, further compounding the problem. Such funds usually invest a portion of their assets in bank deposits. (Forbes)

Moody's sees local default in China as CNY 127bn matures

Jul 26. Chinese local-government financing need to repay a record amount of maturing debt in the second half of 2013, prompting Moody's Investors Service to warn the new Chinese leadership may set an example by allowing China's first onshore bond default. This may come as the government seeks to shift the focus of the world's second largest economy away from government-led investment. CNY 127bn of notes issued by local government financing vehicles (LGFV) fall due in the second half, double the CNY 62.7bn due in the first six months of 2013. Refinancing may be a challenge after corporate bond sales slumped to a two-year low in Q2, at the same time policy makers have cracked down on shadow banking activities. CNY 208.8bn of LGFV debt falls due in 2014. (Bloomberg)

ECB says bank loans to private sector shrink most on record

Jul 25. Loans to companies and households by European banks fell 1.6% YoY in Q2, the largest drop since the introduction of the Euro in 1999. Results of an ECB survey released last Wednesday showed that while credit standards for loans to consumers eased for a net 2% of banks, a net 7% of banks tightened conditions for both non-financial corporations and households. Analysts mentioned that the euro-zone's continuing recession hampered demand for loans, contributing to the decline. The drop in lending comes despite greater reported ease of funding, and the recent ECB pledge to keep interest rates low. (Bloomberg, ECB)

KKR Group's TXU stake hanging on USD 1.48bn of bonds

Jul 25. According to CreditSights, it is highly probable that KKR & Co. and TPG Capital may purchase USD 1.48bn of junior debt belonging to Energy Future Holdings Corp. Buying the bonds and converting them into equity would give the buyout firms more bargaining power to push secured lenders of the company's unregulated unit into a reorganization that gives a higher portion of the firm in the hands of the buyout firms. The junior bonds account for about 19% of Energy Future's USD 7.62bn debt, the rest of which comprise of first and second lien bonds. (Bloomberg)

OSX bond's ship claim outdone by BNDES 120% cover

Jul 24. Brazilian state development bank BNDES's conservatism is paying off at a time when even secured bondholders of billionaire's Eike Batista's distressed conglomerate may fail to recoup their investment. BNDES holds letters of guarantee worth 120% of its BRL 1.4bn (USD 632mn) 21-year loan extended in June 2012 to OSX Brasil SA to build a shipyard. In addition, the loans are also secured by rights to real estate, equipment and machinery, and OSX shares in the project. OSX's USD 500mn of secured 2015 notes have fallen more than any emerging-market corporate bond of similar maturity as Batista's flagship oil company EBX Group Co. approaches default, endangering the viability of its sister company OSX. (Bloomberg)

RBNZ signals end to record-low interest rate in 2014

Jul 24. The Reserve Bank of New Zealand kept its Official Cash Rate at a record low of 2.5%. In accompanying forward-looking guidance, Governor Graeme Wheeler said the pace of future interest-rate increases will depend on the effect booming domestic house prices have on inflation, and will keep interest rates at current levels at least through the end of 2013. The NZD remains high and continues to weigh upon domestic exporters. The central bank has said this, in combination with an overheating property market, is a risk to financial stability, and higher interest rates are currently not the best policy response. (Bloomberg)

Bad real estate deals return to haunt Detroit's pensions (Bloomberg)

China central bank chief says to improve financing for small firms (Reuters)

Euro zone economy set to grow in current quarter – PMIs (Reuters)

Greece gets green light for EUR 4bn payment, EU says (Reuters)

IDR falls to four-year low on Fed tapering concern (Bloomberg)

Philippine bonds, PHP rise as Moody's signals possible upgrade (Bloomberg)

S&P cuts rating on 18 medium-sized Italian banks (Reuters)

Singapore home prices climb to record as loan curbs imposed (Bloomberg)

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