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Credit Research Initiative

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Weekly Credit Brief June 24 - June 30

New York Attorney General's accusation hits Barclays' RMI 1-year PD

The latest accusation from legislators has taken a hit on Barclays' market capitalization, and thus affecting the firm's RMI 1 year probability of default (RMI PD). The company's RMI PD shot up at least 20bps since end May 2014 to a 2-year high of 154 bps on June 27. The upward trend is also reflected in RMI's long term risk benchmark as the 5-year probability of default climbed to 579 bps from 526 bps at the end of May. The bank's market cap slumped to the lowest level since early 2013, falling from GBP 48bn in January 2014 to GBP 35bn last Friday.

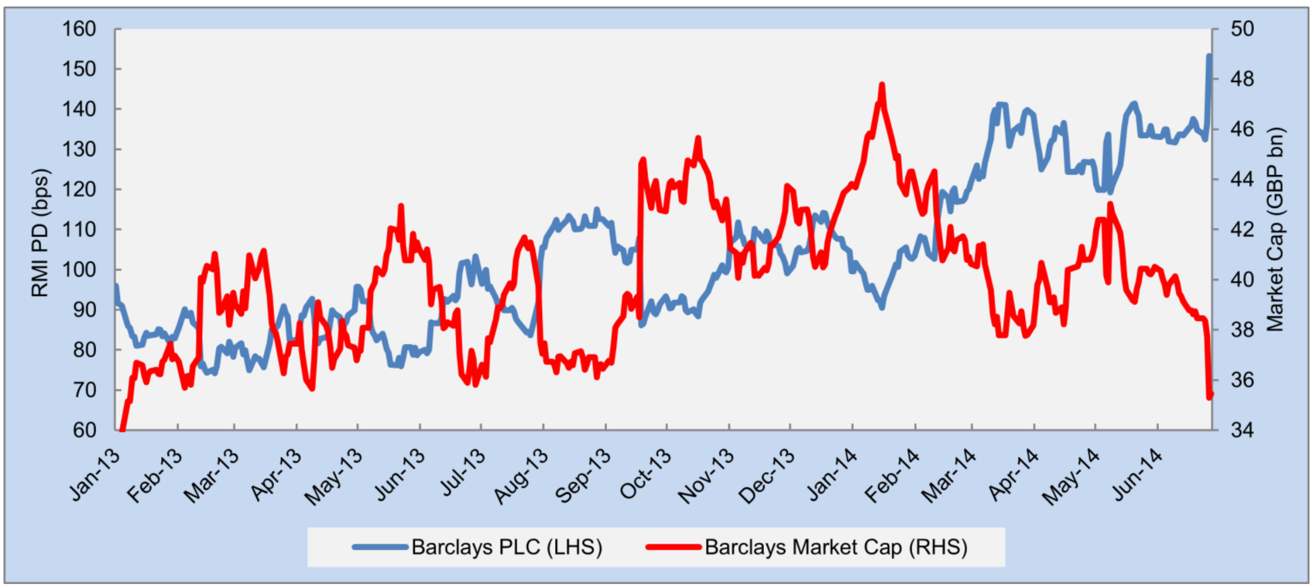

Figure 1: Chart of RMI PD for Barclays vs market cap. Source: *The Risk Management Institute, Bloomberg*

The British lender has faced an immediate exodus of clients from its private stock trading platform called Barclays LX after the New York State Attorney General filed a lawsuit against the firm, accusing the bank of relying on false and misleading marketing material, promising investors that they would be protected with the help of built-in safeguards against toxic, predatory and aggressive high frequency traders (HFTs). Broker dealers have also removed their network connections to the platform, which utilizes a smart order router to access liquidity in both displayed and non-displayed locations, which includes all major US exchanges, electronic communications networks and various alternative trading systems. Dark pools were originally private trading venues designed to help institutions trade orders unavailable to the public anonymously. These liquidity venues have increased in size through time after attracting a greater audience like micro second traders.

Before brokers started pulling out on Thursday, Barclays had one of the biggest dark pools in the country by volume, with more than 90mn shares traded in May, second to Credit Suisse's Crossfinder, which registered trades for more than 110mn of stocks. This was based on information disclosed by the Financial Industry Regulatory Authority, which started publishing this data from June 2. UBS ATS, which was launched in 2008, recorded an average volume of more than 79mn shares during the same period.

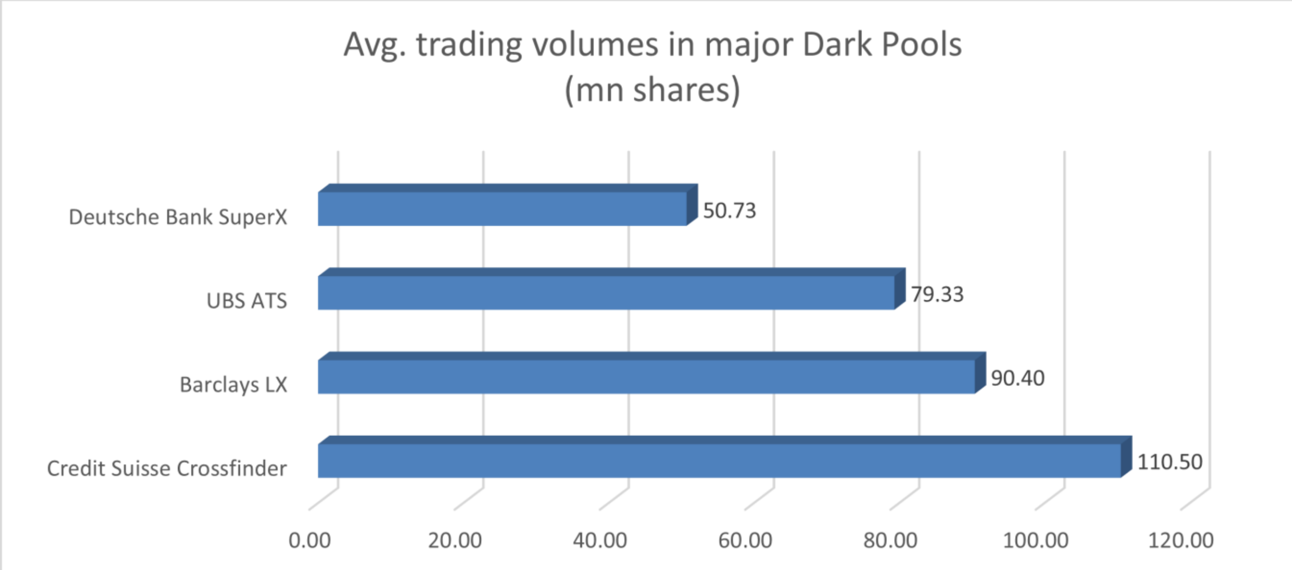

Figure 2: Average volume for major dark pools for the weeks of May 12 and May 19, 2014. Source: *FINRA, Thomson Reuters Datastream*

The situation surrounding Barclays illustrates a growing trend across the banking sector, where regulators have steadily increased their supervision on banks. Penalties for breaching the rules have been steep; BNP Paribas is set to pay USD 8.9bn to US federal authorities for transferring billions of dollars on behalf of Sudan and other countries blacklisted by the United States. The United States government initially requested for a USD 10bn fine which was immediately objected by the French President. Research by SNL Financial showed that the 6 major US banks – JP Morgan, Bank of America, Citigroup, Wells Fargo, Goldman Sachs and Morgan Stanley have agreed to pay USD 67bn in fines due to financial misconduct during the 2008 Financial Crisis.

Barclays is already besieged with falling revenues with the bank reported losses of GBP 835mn, GBP 168mn and GBP 642mn in Q4 2012, Q2 2013 and Q4 2013 respectively, and the company had recorded declines in net revenue during 2012 and 2013 due to poor performances in investment banking and fixed income trading. The latest allegation will put a further dent to its image as shareholders and brokerage houses ditched Barclays. In addition to its involvement in serial financial scandals – including the manipulation of interest rates and gold prices – the bank now stands accused of fraud related to its “dark pool,” essentially a private stock exchange.

Credit News

New debt restructuring law passed in Puerto Rico

Jun 29. Puerto Rican agencies such as the island’s power, water and transportation authorities have been allowed to restructure their debt and negotiate with bondholders to change their debt burdens. The move by the government however is being challenged by the Franklin Templeton and Oppenheimer Funds who are asking the US District Court for the District of Puerto Rico to block the law. The value of these Puerto Rican bonds has declined because the terms of the notes have been changed. The fund management companies complaint that the new law provides for an unconstitutional taking of property, as it allows the Puerto Rican authorities to seize the collateral securing the bonds. (WSJ)

Crisis looms at cash strapped Dongbu Group of Korea

Jun 27. South Korea's 18th largest conglomerate may be facing further financial risk as its self-rescue plan has been delayed. Last year, the group planned to raise KRW 3tn after it listed its key affiliates and other assets for sale but POSCO withdrew its bid for a steel mill held under the Dongbu group. Time may be running out for the company as the manufacturing unit has to refinance or pay back debts amounting to USD KRW 220bn this year. There is little cash on the group's balance sheet and the firm may default on the notes. Creditors such as Korea Development Bank are asking for a stake in the group's insurance arm as collateral. (Yonhap)

EUR 9bn of SME loans in Ireland are now in default

Jun 26. One in every four loans lent to Irish small and medium enterprises (SMEs), which now count 99% of businesses in the country, was found in default. Though having been falling steadily since 2010, the total amount of loans borrowed has reached 21bn euro at the end of last year with an average SME borrowing 71101 euro. Yet gross new lending has been static between 450mn and 750mn euro per quarter. The default rate has hit 26.05% with the rate on the balance reaching 41.38%. Companies with a bigger loan size were found more likely to default, and construction and hotels were the ones that had the most number of defaults. In addition, one in every six Irish SMEs had high level of debts, and hotels and restaurants were the most indebted sectors. (The Independent)

Arabtec topples fragile Dubai market fuelled by belief

Jun 25. Dubai's largest listed construction company Arabtec Holding shocked investors when state owned investor Aabar Investments PJSC considered withdrawing support for the company. Following the announcement, the ex CEO of the company resigned and the firm began laying off a number of its employees. All real estate projects by its subsidiary Arabtec Properties were immediately halted, barely six months after the real estate development unit was launched. The sharp drop in the company's market cap brought about losses through the broader market as investors who bought shares through leverage had to sell their stakes in other equities to meet margin calls. Observers say the company's collapse highlights transparency problems and a lack of governance for Dubai listed firms. (Bloomberg)

China banks join Japan's with 50% loan surge (Bloomberg)

UK mortgage approvals drop to 11-month low (The Telegraph)

Emerging-market issuers vulnerable on $2 trillion debt binge (Bloomberg)

Bulgaria's bank crisis eases after Europe approves credit line (Reuters)

Regulatory Updates

Mainland China banking regulator to ease loan-to-deposit ratio

July 1. The China Banking Regulatory Commission is going to remove three types of loans from the regulatory scrutiny. Funds lent under the central bank's re-lending facility to small enterprises and commercial bank loans from international financial institutions or foreign governments will not be scrutinized by the regulator starting July 2, 2014. This is part of an effort by the regulator to release more cash into the economy and boost economic growth towards China's target of 7.5% annual economic growth. (South China Morning Post)

Bank stress tests still evolving and transformative

June 25. Federal Reserve Governor Daniel Tarullo, supervisor of the stress test system and of other Dodd-Frank reforms, said on June 25 that the US stress tests for banks were working well because they are constantly evolving, incorporating industry criticism and suggestions. The Fed extended the deadline for Citigroup, HSBC, RBS and Banco Santander until next year so that the lenders may revise their capital plans after objecting to earlier versions. The governor said that new risk assessment measures for banks will be implemented in future and institutions have to fix any weaknesses identified in the process. Future stress test scenarios would also be stricter as they incorporate the assumption of increased cost of bank funding. (MNI Deutsche Borse)

The Monetary Authority of Singapore rolls out new framework to strengthen banking oversight

June 24. Singapore's monetary authority will implement new supervisory guidelines for domestic systemically important banks (D-SIBs) in order to improve the resilience of the financial system. In a consultation paper released on June 25, MAS outlined a methodology to assess the systemic importance of banks. In addition, the central bank listed new rules for D-SIBs. One of the requirements of the new framework involves banks with significant retail presence to locally incorporate their retail operations in Singapore. Local banks would also need to follow the regulator's recommendation for liquidity coverage ratios (LCR) which are in line with the guidelines set by the Basel Committee. The new rules will require locally incorporated banks and systemically important foreign banks to maintain 100% local-currency LCR from January 2015. An all-currency LCR will also be implemented, starting at 60% in 2015 and rising in annual 10pp steps to 100% by 2019. LCR requirements of 100% and 50% for SGD and foreign-currency liabilities, respectively begin January 2016 (Today News, Reuters)

After crisis, risk officers gain more clout at banks (WSJ)

Lenders are warned on risk (WSJ)

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