Weekly Credit Brief Mar 21 - Mar 27 2023

Credit risk of Eurozone banks rises as contagion jitters beset global markets

by NUS-CRI Market Monitoring Team

- **The NUS-CRI Agg PD for Eurozone banks and ECB's significant institutions indicates that the ECB's stance on Eurozone's robust financial system might underestimate the build-up of systemic risk, when compared to the Agg PD of the top 30 CriSIB**
- **NUS-CRI Forward PD suggests that the Eurozone banking sector's credit risk is set to rise as depositor outflow, in the midst of the current liquidity crunch, may raise funding costs and hinder Eurozone banks' profitability and asset quality**

Global banks around the world are witnessing heightened market fears as the closure of large, systemically important banks ripple signs of worry across the industry. The failure of SVB, Signature Bank, and Silvergate bank, as well as the distressed acquisition of Credit Suisse AG by UBS AG, has deepened contagion fears regarding global banks' financial health. Operating in the fallout zone are Eurozone banks, which are feeling the effects of the crisis of confidence as rapid depositor outflows raise concerns regarding their solvency and ability to weather the recent banking crisis. As seen from the NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) in Figure 1a, the median credit risk for the Eurozone banking sector has been rising since the beginning of last year, in line with the worsening macrofinancial environment. Rising interest rates are plaguing banks' balance sheets and are leading to large deposit outflows as depositors migrate toward higher-yielding assets. Meanwhile, the NUS-CRI Aggregate (median) Forward 1-year PD (Forward PD[1]) suggests that the median credit risk is set to rise over the next twelve months, still remaining above the BBB- upper bound when referenced to PDiR2.0[2], as the European Central Bank (ECB) continues to hike rates and systemic fragility in the banking system impacts the banks' profitability and capital base.

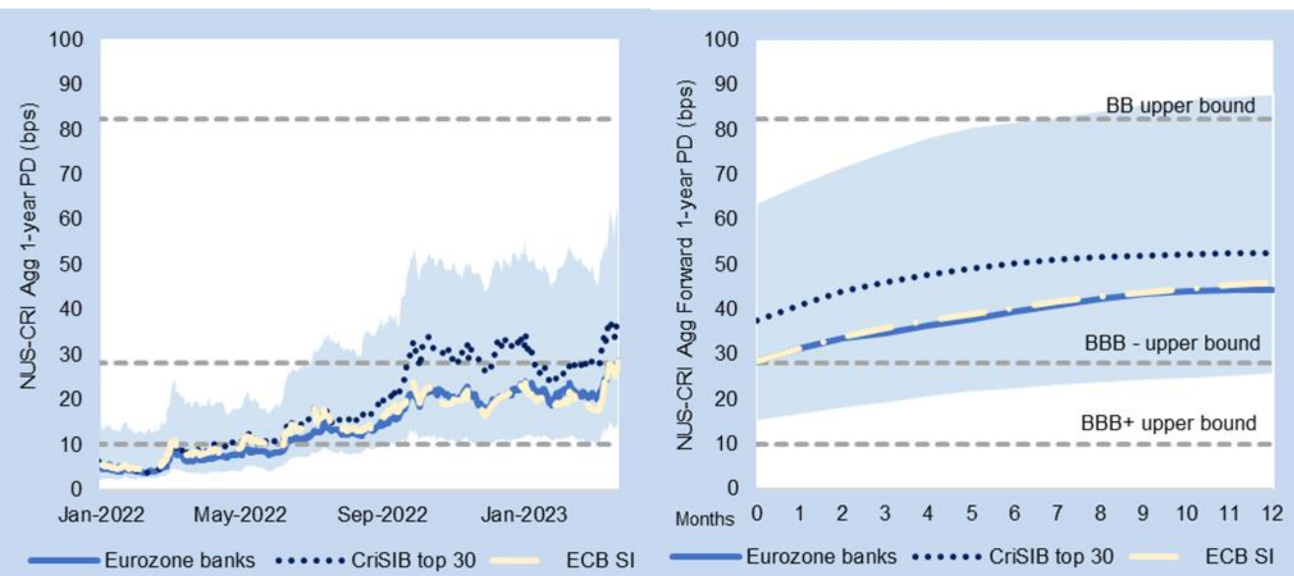

Figure 1a (LHS): NUS-CRI Agg (median) 1-year PD for Eurozone banks, CRiSiB[3] top 30 banks, and publicly-listed ECB significant financial institutions with reference to PDiR2.0 bounds and its interquartile range. Figure 1b (RHS): NUS-CRI Agg (median) Forward 1-year PD for Eurozone banks, CRiSiB top 30 banks and publicly-listed ECB significant financial institutions as of Jan-2023, with reference to PDiR2.0 bounds and its interquartile range. *Source: NUS-CRI*

[1] 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.

[2] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation by 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.

[3] CriSIB is the ranking of systemic importance for exchange-listed banks around the world. It is dynamic by nature, and it determines a firm's systemic risk by its size and interconnectedness with others. A higher ranking of a firm means it is likely to pose a larger threat to the global (group) financial system.

The ECB's decision to raise interest rates by a further 50bps on Mar 16th, 2023 to 3%, signaled to global markets that the central bank's priority is combating inflation rather than providing stimulus to the banking sector.[4] Christine Lagarde, the President of the ECB, stated that she believed the European banking system is robust to the shocks arising from the failure of major US banks. Referencing the coverage of the ECB's significant financial institutions, the Agg PD of all ECB's publicly-listed SIs[5] (ECB SIs) showcases a trend similar to the median credit risk faced by all banks in the Eurozone (See Figure 1a). However, when compared to the credit risk of the top thirty NUS-CRI Systemically Important Banks domiciled in Europe (CriSIB), the Agg PD of the top 30 CriSIBs is higher than that of ECB SIs (See Figure 1a). This may suggest that in tandem with the Eurozone banks' median credit risk, as well as that of ECB's SIs, worsening, the ECB's stance on the banking system's underlying credit health may underestimate the build-up of systemic risk, and vis-a-vis, the increased likelihood of cross-default between banks.[6]

For context, the contagion stemming from the US banking crisis has led to a rout in the Eurozone banking sector, which saw the STOXX Europe 600 Banks index decline 16% in Mar-2023. A simultaneous sharp rise in European banks' CDS in Mar-2023 (See Figure 2a) indicates the market's perception of rising default risk. Additionally, as the ECB continues to hike rates without a substantial increase in deposit rates the banks may face a decline in deposit levels and may have to resort to raising retail deposit rates. For example, although the ECB has hiked rates to 3%, depositors in German banks only received a maximum of 1.6% on their holdings with banks. To reverse the tide of declining deposits, banks are likely going to be pressured to offer higher rates, increasing their funding costs[7].

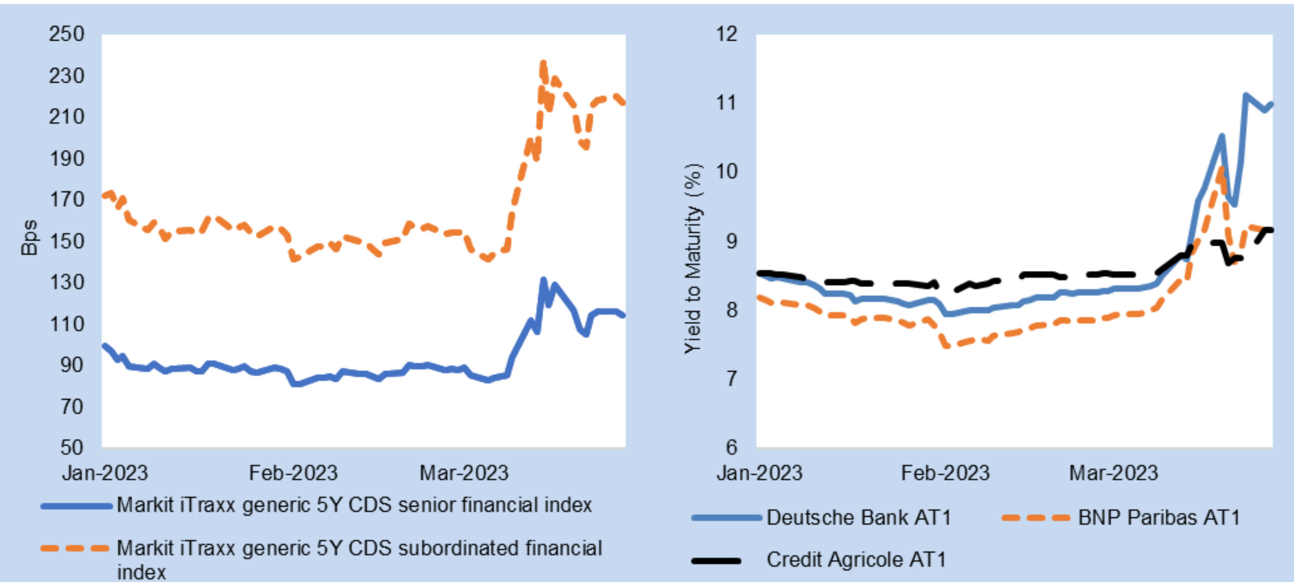

Figure 2a (LHS): Markit iTraxx generic 5Y CDS senior financial index and Markit iTraxx generic 5Y CDS subordinated financial index Figure 2b (RHS): YTMs of additional tier 1 bonds issued by some major banks in Eurozone *Source: Bloomberg*

To add to the sector's woes, the fallout of Credit Suisse has stirred concerns over Eurozone banks' credit health. The regulator's write down of Credit Suisse's AT1 bonds as part of its acquisition by UBS has triggered turmoil in the USD 250bn AT1 bond market, with average yields for AT1 bonds issued by Eurozone banks spiking by close to eight percentage points to 15.3%. Access to the AT1 market, which has long been a source of essential funding for Eurozone banks, may remain hindered in the near future. Furthermore, liquidity levels remained a key concern as events leading to the collapse of SVB and Signature bank attracted critical scrutiny. Although Eurozone banks maintain a strong liquidity profile, with the aggregate liquidity coverage ratio at 162% for the sector, they have been subject to significant declines in deposits ever since the ECB started to raise interest rates in 2022. In Feb-2023 alone, depositors had withdrawn a record EUR 71.4bn from Eurozone banks, the largest MoM decrease on record, migrating to assets that generate higher yields. As such, Eurozone banks are poised to reduce loan growth in the near future, impacting both their profitability and asset quality as hindered access to necessary funding might impact Eurozone's non-financial corporates' ability to service their debt,

[4] A similar decision by the US Federal Reserve to raise rates by 25bps on Mar 22, 2023, signaled the same sentiment. However, the Fed, amongst other federal agencies, has already provided backstops to financial institutions pertaining to the ongoing bank failures.
[5] A complete list of all ECB's SIs can be found here. Of the 111 financial institutions considered significant, 46 of them are publicly listed and make up the sample of ECB's publicly-listed SIs.
[6] For more details regarding the institutions with a larger connectivity (higher partial default correlation) with the CriSIBs, and thus a higher likelihood of cross-defaulting, please go to the CriSIFI visualization dashboard here.
[7] A survey by the European Banking Authority (EBA) indicated that in Dec-2022, 57% of surveyed banks planned on increasing rates on retail deposits as compared to 20% in Apr-2022

especially in a high-borrowing-cost environment. Meanwhile, large international systemically important banks tend to be more easily impacted by overseas shocks given their exposure to foreign assets, possibly suggesting why the Agg PD of the top 30 CriSIB increases above the Agg PD of Eurozone banks in Figure 1a. The ECB in Jan-2023 warned of systemic risks in the Eurozone banking sector due to its exposure to domestic and foreign commercial real estate as rising borrowing costs have already led to a decline in property values. Furthermore, Eurozone regulators are encouraging initiatives for processing sales of NPLs on secondary markets for sustaining the financial system.

Nevertheless, it is important to note that Eurozone banks have maintained strong capital positions entering the recent crisis, with the banks' CET 1 ratio at 14.75% in Q3 2022, sufficiently above the 10.7% requirement. Another aspect that underlines the Eurozone banking sector's credit health is the strict supervisory and stress testing requirements which help identify warning signs in a timely manner. The robust capital base of Eurozone banks may prevent any severe worsening of the sector's credit risk in the absence of a sudden systemic shock. However, the tightening credit conditions in combination with expectations of weaker economic growth[8] in the coming quarters are projected to negatively influence bank profitability and asset quality as seen from the upward-sloping term structure of the NUS-CRI Forward PD in Figure 1b.

[8] The International Monetary Fund projects the GDP growth of the Euro area to sharply decline to 0.7% in 2023 as compared to 3.5% seen in 2022.

Credit News

Credit Suisse write-off upends European bank capital bonds

Mar 23. The complete write-off of Credit Suisse's AT1 bonds pushed by UBS executives to reduce the burden of the acquisition has stirred concerns over the compensation order in insolvency. The recent Swiss law change effectively granted Swiss regulators the authority to make this decision quickly. Regardless of the legal justification, the wipeout has damaged confidence in the AT1 market, which is valued at around USD 250bn, and may cause an increase in funding costs for European and Asian banks. UK and EU regulators have reassured AT1 bondholders that shareholders would suffer losses before bondholders in any future bank failures. The market faces another test in May when there is a call date for a bond issued by UniCredit SpA. (WSJ)

Anxiety strikes USD 8tn mortgage-debt market after SVB collapse

Mar 22. The recent collapse of Silicon Valley Bank has caused concern in the USD 8tn agency mortgage bond market, which is considered almost as safe as US government bonds due to its backing by mortgage loans from government-controlled lenders Fannie Mae and Freddie Mac. Agency mortgage bonds are widely held by banks, insurers, and bond funds. Although the bonds are considered less likely to default than most debt, they are vulnerable to rising interest rates and their prices are subject to fluctuations. With the Federal Deposit Insurance Corp. taking over Silicon Valley Bank, investors anticipate that its bonds will be sold off in the upcoming months, increasing supply to the weakened market and pushing prices lower. (WSJ)

Commercial property risks rise up bank investors' worry list

Mar 23. US banks are increasingly concerned about commercial property loans, which are becoming the largest perceived risk alongside deposit flight and bond portfolios. Fed's rate hikes have led to higher borrowing costs and weaker property valuations. Analysts warn that a reduction in lending could make the situation worse. Commercial real estate loans account for 43% of small banks' total lending and most of these loans are not repackaged for the asset-backed securitization markets. Concerns about the sector have been heightened following the collapses of Silicon Valley Bank and Signature Bank. (FT)

High-grade borrowers storm the market ahead of Fed rate decision

Mar 22. Before the Fed's announcement regarding a rate hike, investment-grade companies, primarily utilities, took advantage of the recent drop in funding costs and issued new bonds. These companies sought to capitalize on the market's risk aversion following bank failures, while rates were still relatively low. In the coming weeks, it is anticipated that high-grade issuance will continue to dominate the market. However, potential new issuers may be hesitant to enter the market due to a lack of confidence. (Bloomberg)

China Evergrande offers bond, equity swaps in debt

Mar 23. China Evergrande Group has announced its plans to restructure its offshore debt worth USD 22.7bn, providing creditors with options to exchange their debt into new bonds and equity-linked instruments supported by the company and its two Hong Kong-listed subsidiaries. The property developer, which has total liabilities exceeding USD 300 bn, has been at the center of a property debt crisis in China that has led to multiple defaults by developers, resulting in debt restructuring talks. The company anticipates finalizing restructuring support agreements with various bondholder groups by Mar 31st, with restructuring taking effect on Oct 1st. (Nikkei)

Investors pile Into government bonds, tech after Fed announcement (WSJ)

U.K. inflation rise boosts pound, hits bonds (WSJ)

First Citizens to buy SVB after biggest failure since 2008 (Bloomberg)

Regulatory Updates

Fed raises rates but nods to greater uncertainty after banking stress

Mar 22. The Fed has approved its ninth consecutive interest rate hike, which brings its benchmark federal funds rate to a range between 4.75% and 5%, the highest level since September 2007. However, Fed Chair Jerome Powell has hinted that the recent bank turmoil following the closure of Silicon Valley Bank and Signature Bank could put an end to the rate-rise campaign sooner than previously anticipated. Powell said that this week's increase could be their last one for now, depending on the extent of any lending pullback that follows the bank run earlier this month. While stocks initially rose after the announcement, they slumped in the afternoon. (WSJ)

China's surprise loan easing to bolster fragile economic growth

Mar 21. The People's Bank of China has taken the unusual step of cutting the reserve requirement ratio (RRR) for financial institutions by 25bps, in a move to boost liquidity and support China's economy, which is recovering from the impact of zero-COVID policies. This is the first such cut since December 2022, and it is expected to release CNY 500bn to CNY 600bn (USD 72.6bn to USD 87.2bn) of liquidity into the market when it takes effect on Mar 27th. The decision came as a surprise to market watchers, who had anticipated a cut to the RRR later in the year. (Nikkei)

Banking stress puts US and Europe on watch for credit crunch (Reuters)

Chinese regulation seen boosting AT1 bond prices during crisis (Nikkei)

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