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Weekly Credit Brief Nov 17 - Nov 23

Ally Financial eyes subprime again, this time in auto

by KHAW Ker Wei

Following its debut on the New York Stock Exchange in December 2014, the 1-year RMI-CRI Probability of Default (PD) for Ally Financial (Ally) has climbed above the 100bps mark and remains at that level since (see Figure 1). Ally is one of the largest automotive lenders in the US. It is the surviving business entity of what is left of General Motors Acceptance Corporation (GMAC) after the 2008 financial crisis. In the years leading to the crisis, mortgage loans comprised almost half of GMAC's total assets, held through its subsidiary GMAC ResCap. When the bubble eventually burst, the company had to be injected with a total of USD 17.2bn in bailout funds under the Troubled Asset Relief Program, which effectively placed it under the ownership of the US Treasury. GMAC subsequently wrote off much of its subprime mortgage assets and rebranded itself as Ally Financial in the process. Now, Ally focuses on direct banking and its profitable, core automotive lending business.

Ally's current financial situation is by no means appalling. After ridding itself of the subprime mortgage mess, the company has been generating profits on an annual basis. In the last two years, its revenue has grown at a compound rate of 8.6% annually. Further indications that the business is indeed profitable can be observed from its trailing 12-month net interest margin, which expanded steadily from 1.4% in the first quarter of 2014 to almost 2% as of the end of the most recent quarter. Notably, the increase in profitability did not come from pursuing debt-engineered expansions. Long-term borrowings grew only a modest USD 4.6bn while short-term borrowings remained pretty much flat during the two years. On the other hand, total deposits expanded by USD 10.3bn - providing the cheap source of funding the company needs to maintain or boost its net interest margin.

Despite the healthy balance sheet, Ally's valuation appears to be weak at present. Among lenders with more than USD 30bn of assets in their automotive loans portfolio, Ally's price to book value ratio was the lowest, at 0.77 as of 31 October 2015. In contrast, Wells Fargo and JP Morgan had a price to book value ratio of 1.64 and 1.09 respectively. The under-valuation appears to be confounding at first but a deeper assessment of Ally's business environment would provide some justifications.

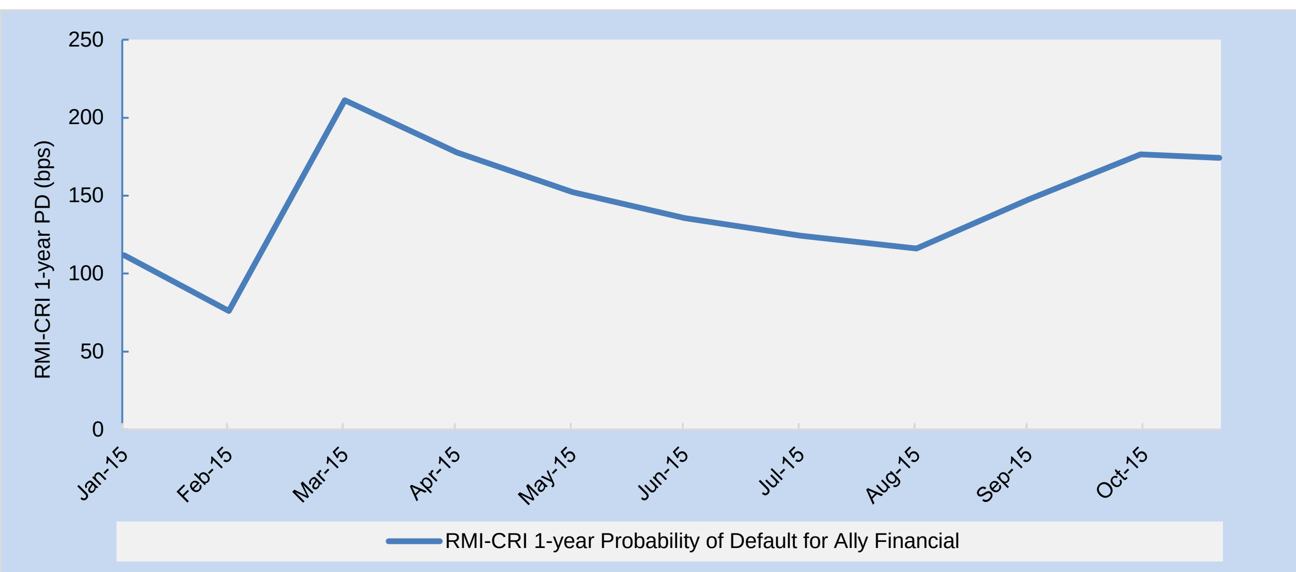

Figure 1. RMI-CRI 1-year PD and market cap for Ally Financial. *Source: RMI-CRI*

Competition within the automotive lending space is intense, even though the industry has been growing at record pace in recent years, fueled by low gas prices. The total outstanding automotive loans surged past USD 1 trillion in the US for the first time in the second quarter of 2015. In its third-quarter earnings call, Ally's CEO Jeffrey Brown communicated that the company will step up in extending loans to borrowers with lower credit scores to bring its underwriting practices closer to its peers. With a trailing 12-month net interest margin of 2%, Ally's business is profitable. However, Ally lags the competition as its larger peers are able to boast of margins that are on average, 40bps higher. In the latest reporting quarter, subprime exposure accounted for about 15% of Ally's loan origination, compared to the US industry average of approximately 35% (see Figure 2). While the collapse of an automotive loan bubble is unlikely to pose a systemic risk to the economy given the size of the exposure, the memories of Ally's bailout by the government is probably enough to stir bearish sentiments in investors. Furthermore, automotive loans made up 87% of the company's total assets as of 30 September 2015. If Ally does indeed increase its subprime exposure towards the industry average, a sudden deterioration of consumer credit overall could lead to massive losses and again, put the company in a distressed position. Unlike its larger, banking competitors, Ally's loan portfolio does not provide it with the benefit of asset class diversification, which could help it absorb shocks from a major credit event in the automotive lending industry.

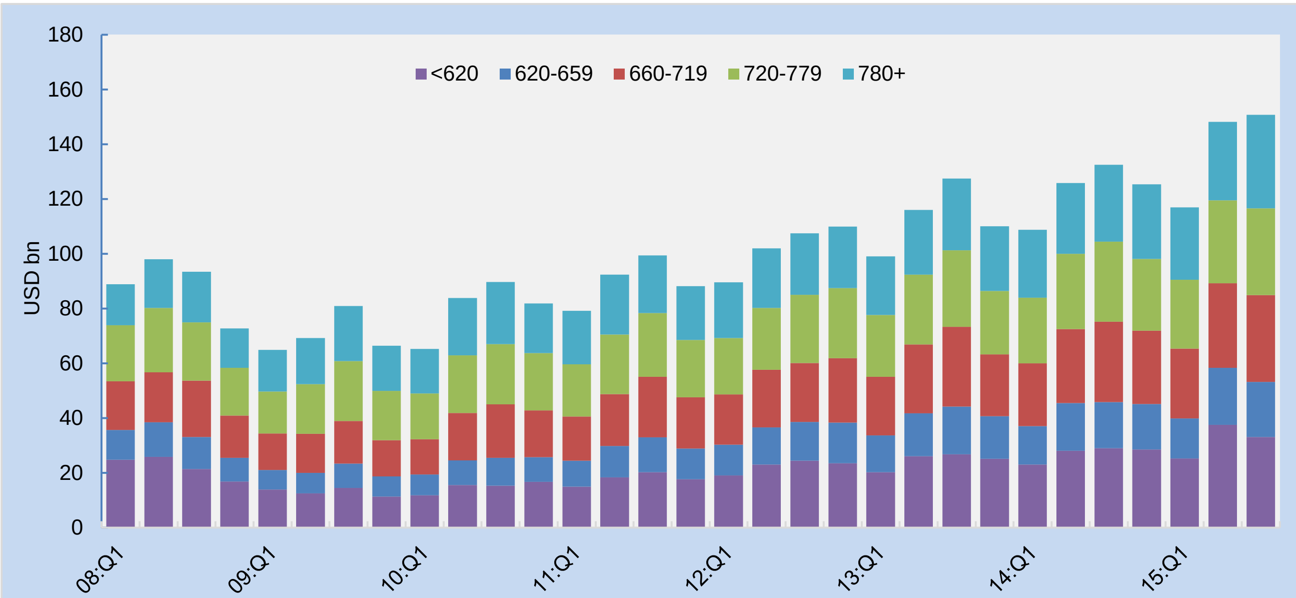

Figure 2. US auto loan originations by credit score. *Source: FRBNY Consumer Credit Panel/ Equifax*

In the nearer term, the first interest rate hike by the Fed in almost a decade is also seen to generate headwinds for the profitability of the company. Ally remained in a liability sensitive position as of the end of the third quarter of 2015. Under the assumption of a long-term deposit pricing pass-through rate of 80%, Ally is set to make a loss of USD 7mn if the interest rate increases gradually over the course of the year. The loss is expected to jump to USD 50mn should the interest rate hike happens instantaneously.

Ally rescinded itself of public ownership in December 2014 when the US Treasury sold off the last remaining shares for a profit of USD 2.4bn. The exit put an end to a multi-year government bailout program – fortunately, at no financial losses to taxpayers. More importantly though, Ally's management needs to be mindful about the true cost that was involved in bailing out the company. The expansion of subprime loans could boost its earnings over the short horizon but, on the basis of a risk-reward evaluation, the decision may end up sinking it a second time. When that happens, it can be reasonably assumed that there will be no Bailout 2.0, given that the US regulators have already stated their intent late in October 2015.

Credit News

Devaluation watch may force China to pay premium on Dim Sum debt

Nov 23. China is set to pay more to sell sovereign bonds in Hong Kong than in the onshore market for the first time, as investors brace for the possibility of another yuan devaluation. The Ministry of Finance will sell RMB 14bn (USD 2.2bn) of Dim Sum notes in the city this week, including RMB 2bn to individuals. The yield on offshore yuan securities due 2020 was 3.39% on Nov. 20, 25bps higher than debt of the same maturity in Shanghai, suggesting the government will have to pay more to borrow outside of the country. (Bloomberg)

Fitch doubts Modi budget as USD 15bn salary boost hurts bonds

Nov 22. A proposal to increase the salaries of millions of Indian civil servants risks the government's budget deficit goal, adding to pressure on bonds suffering the biggest outflows since May. The government bonds fell after the proposals were announced Thursday, pushing up the benchmark 10-year yield by 3bps the following day to 7.71%, the highest since Nov 9. S&P and Fitch rate India's debt at BBB-, the lowest investment grade, with a stable outlook. Moody's Investors Service has a similar ranking of Baa3 with a positive outlook. (Bloomberg)

China has an SGD 1.7tn Ponzi finance problem as debt piles up

Nov 20. Chinese borrowers are taking on record amounts of debt to repay interest on their existing obligations, raising the risk of defaults and adding pressure on policy makers to keep financing costs low. According to Beijing-based Hua Chuang Securities, the amount of loans, bonds and shadow finance arranged to cover interest payments will probably rise 5% this year to a record RMB 7.6tn (SGD 1.69tn). Chinese companies are struggling to generate the cash flow needed to service their obligations as economic growth slows to the weakest pace in 25 years and corporate profits shrink. (Straits Times)

Singapore government bonds hit by sliding currency

Nov 20. The falling SGD has adversely affected the demand for Singapore bonds; SGD has depreciated by 7% against the USD since the start of the year. The main reason cited for the depreciation is the monetary easing policy implemented by MAS. MAS used this policy to boost the economy of the city state amidst the slowdown in global trade and the deflationary pressures from abroad. Furthermore, investors are shunning from Singapore assets due to the expected higher return in US assets from a potential hike in the interest rates. The yield spread between Singapore bonds and US Treasuries has also increased, hitting a record of 73bps since 1998. (Straits Times)

Atna Resources files for chapter 11 bankruptcy protection

Nov 19. Atna Resources Ltd., a gold mining company, has filed for chapter 11 bankruptcy protection, in order to streamline its operations and restructure its debts. The firm requested for a USD 4mn financing package to restructure its debts, subjected to approval from court. The company is intending to default on its existing loans as it has a liquidity crunch; it has only USD 200,000 in cash this week. The main reasons for the liquidity problems and the gloom outlook of the company are the lack of demand for the idle mining equipment and the nosediving of Q3 production at one of its mines. (WSJ)

Moody's upgrades Ukraine's sovereign rating, changes outlook (Sputnik)

Taiwan considers lifting China semiconductor ban (FT)

China home-price recovery slows in October amid supply glut (Bloomberg)

Regulatory Updates

Wall Street regulators said to step up leveraged-loan focus

Nov 20. Federal regulators have started to intensify their scrutiny of risky company loans extended by Wall Street's biggest banks, just weeks after completing an annual audit of corporate lending. The Fed, OCC and FDIC have already completed this year's joint annual credit review of Wall Street underwriters' loan portfolios. The regulators again pushed banks to comply with the leveraged lending guidelines first published in 2013 and have been flagging more loans as problematic this year than in the past. (Bloomberg)

Basel plays down impact of trading rule changes on capital

Nov 18. The Basel Committee claimed that overall capital requirements for the biggest banks would rise by 4.7% under planned rules to ensure lenders set aside enough capital to cover the risk of trading book assets turning sour. Most banks must currently hold minimum capital equivalent to about 7% of their risk-weighted assets under Basel III rules. The increase is heavily skewed by a handful of big, global trading banks like JPMorgan and others. Basel said aggregate capital charges for market risks would rise on a weighted average basis by 74% compared with the current rules. (Reuters)

UK Financial Conduct Authority to scrutinize asset management industry

Nov 18. The UK Financial Conduct Authority (FCA) will hold an antitrust review of the UK's GBP 6.6tn asset management industry. UK FCA would investigate how costs are controlled and the role of investment consultants on competition among institutional asset managers. The review began after a falling-out in the industry — the head of the Investment Association, Daniel Godfrey, was overthrown by the members because he wanted to reform the fee structure. The FCA has already voiced its concerns to asset managers regarding their lackluster efforts to prevent insider trading and market abuse. (FT)

After market crash, China mulls single 'super-regulator' (Reuters)

China cracks USD 64bn `Underground Bank' moving money abroad (Bloomberg)

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