FIG in Focus

Welcome to the third edition of our regular briefing on news and views in the FIG (financial institution group) world.

These are the stories and insights that have captured our attention in recent months.

We would also like to take this opportunity to wish you all the very best over the holiday period and into the New Year.

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IN THIS ISSUE

Performance – Why it Pays to Pay Attention

Closely following market sentiment, especially negative market views – falling share prices, widening CDS spreads etc - can be very helpful in bringing latent issues about a company to our attention. However, as the Wall Street Journal highlighted recently: "There is no substitute for fundamental research."

This was the opening sentence in the Journal's coverage of Melinta Therapeutics, the New Jersey biopharmaceutical firm, whose shares lost two thirds of their market value the day after the company announced it was filing for bankruptcy on 2 January 2020. The journalist pointed out that management had given investors warning in Melinta's 10Q SEC filing on 12 November 2019 that explicitly stated:

> *"….. while we continue to evaluate alternatives to address our liabilities outside of a bankruptcy process, it likely will be necessary for us to commence proceedings under Chapter 11 of the U.S. Bankruptcy Code, and we anticipate that, in any such Chapter 11 proceedings, holders of our equity securities (or claims and interests with respect to, or rights to acquire, our equity securities) would be entitled to little or no recovery, and those claims and interests may be cancelled for little or no consideration. If that were to occur, we anticipate that all or substantially all of the value of all investments in our equity securities would be lost and that our equity holders would lose all or substantially all of their investment."*

Perpetually in search of early warning indicators of pending distress, we do well tracking prices and spreads to get a sense of market sentiment. So when events like this occur we ask ourselves: Markets are supposed to be efficient; how could this happen? How could so many have missed this clearly sign-posted warning?

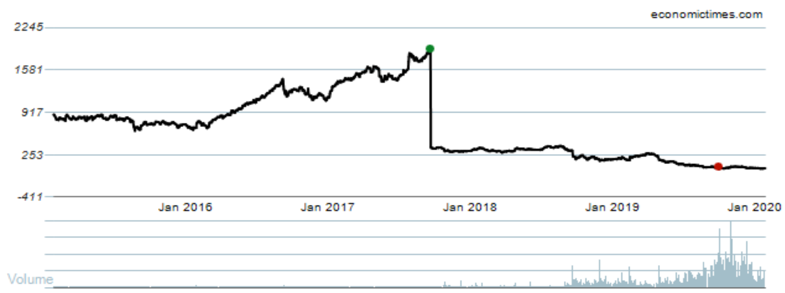
For those of us who cover banks, there is an analogy to this story. When Yes Bank, published its 31-3-2018 year end accounts it would appear that few investors took note of the disclosure in the notes to the accounts which showed that the bank had substantially under reported Non-Performing Assets (NPAs). The additional net NPA's – as assessed by the Reserve Bank of India (RBI) - amounted to ~18% of book capital. (Balance sheet equity was Rs 257,525 million at year end.) See extract below.

(₹ in millions)

Sr. No	Particulars	
1	Gross NPAs as on March 31, 2017 as reported by the Bank	20,185.57
2	Gross NPAs as on March 31, 2017 as assessed by RBI	83,737.57
3	Divergence in Gross NPAs (2-1)	63,551.99
4	Net NPAs as on March 31, 2017 as reported by the Bank	10,722.68
5	Net NPAs as on March 31, 2017 as assessed by RBI	58,916.24
6	Divergence in Net NPAs (5-4)	48,193.56
7	Provision for NPAs as on March 31, 2017 as reported by the Bank	9,462.89
8	Provision for NPAs as on March 31, 2017 as assessed by RBI	24,821.38
9	Divergence in provisioning (8-7)	15,358.49
10	Reported Net Profit after Tax (PAT) for the year ended March 31, 2017	33,300.96
11	Adjusted (notional) Net Profit after Tax (PAT) for the year ended March 31, 2017 after taking into account the divergence in provisioning	23,161.28

The net current impact of the aforementioned retrospective slippages due to divergence noted by RBI in October 2017 has been duly reflected in the results for the year ended March 31, 2018.

Despite being fined and publicly criticized for under reporting NPAs in 2016 and 2017, Yes Bank's share price in mid-August 2018 reached an all-time high of Rs 393. The share price began its precipitous fall the day after the bank's 20 September 2018 Stock Exchange announcement that Reserve Bank of India (RBI) had refused Yes Bank's board's request to extend Rana Kapoor's term as chief executive until 2021 but insisted that it end January 2019. (Mr Kapoor was co-founder as well as CEO of Yes Bank) The shares fell to Rs226 on 21 September 2018. The challenges for the bank sadly continued, the bank was unable to raise new capital, as its share price collapsed.



Yes Bank Share Price Graph

Source: BSE https://economictimes.indiatimes.com/yes-bank-ltd/prices/companyid-16552.cms

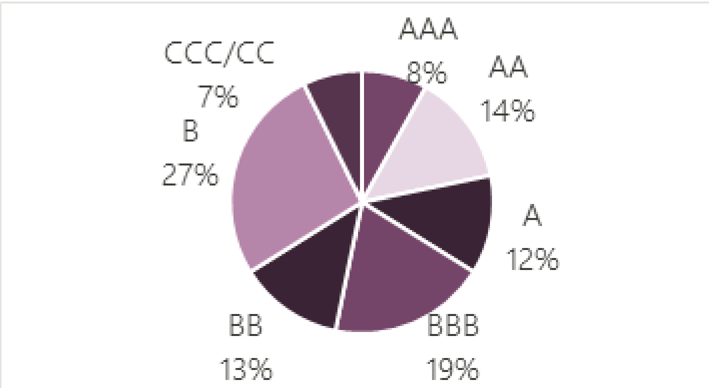
Alas, the story has now come to an end, on 6 March 2020 RBI announced that a rescue has been arranged: State Bank of India would inject Rs 75.2 billion ($975 million) for a 49% stake in Yes Bank, as part of the central bank's resolution plan. The plan includes the cancellation of Rs 108 billion ($1.5billion) AT1 bonds. While the solution was being hammered out, deposit withdrawals were limited to Rs 50K ($670) per person. A sad ending for a bank that was valued at $13.4 billion at its peak in 2017.

The lesson learned? To do our jobs well, we need to both closely track market trends and be timely in our review of the quarterly, as well as year-end results of the firms we follow.

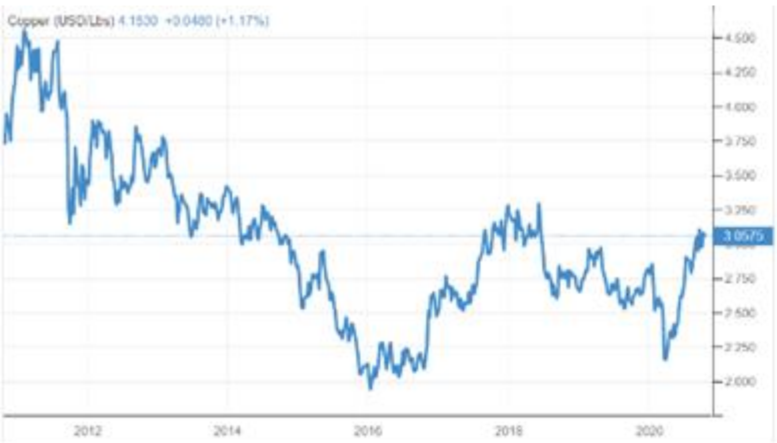
Source: FT 14 March 2020

Is sovereign debt the next crisis?

Fears of a COVD induced repeat of the banking crises from 2008 and 2012 have abated thanks to Central Bank liquidity and the regulatory reforms introduced since then. Might a sovereign crisis still be waiting to happen? We have had 6 sovereign defaults already this year (Lebanon, Ecuador, Argentina (yes again), Zambia, Grenada and Venezuela). This does not include the 43 countries who have deferred payments under the Debt Service Suspension Initiative agreed by public sector borrowers in April this year.



More than a third of sovereigns are now rated B or below by S&P, as shown in the attached chart. Are more defaults to come?



Zambia is an illustrative case of the challenges faced by poor indebted countries.

With a population of 17 million and a GDP per capita of US$1,419, Zambia had reasonably strong growth of 4% pa for the 5 years to 2017. As Africa's second largest copper producer, it enjoyed close relations with China and was a significant beneficiary of Belt and Road Initiative investments. Copper revenues provide 70% of its export earnings but the price has been severely impacted by slowing economic growth in China and the pandemic as shown by the above chart. (In 2000 China represented only about 10% of global demand for copper by 2018 this rose to ~ 50%: Source: World Bank Commodity Market Outlook April 2020.

Zambia owes some $3.5bn in bilateral debt, $2.1bn to multilaterals and $2.9bn to other commercial lenders. It owes about $3bn to China and Chinese entities. The currency (kwacha) has fallen nearly a third since the start of the year, making these payments unsustainable. Interest payments total c. 20% of revenues. High debt service costs arise partly due to non-concessional loans under the BRI financing and also to very high local interest rates. Yields on local currency T bills rose to c. 20% but the Government still has challenges rolling them over with local investors recognising the credit risk even in domestic currency.

In September 2020, Zambia told holders of Eurobonds there would be delays on the payment of $120 million of interest on $3 billion bonds. International investors are demanding equal treatment and greater transparency on the payments of debt service to Chinese lenders. The failure to repay loans to China could lead to the Chinese taking over Zambia's airport, electricity company (Zesco) and major road projects. A Chinese company, Start Times, already controls 60% of a leading national broadcaster. China and other public sector creditors also want private sector investors to share the burden. Luckily, creditors are talking and getting creative. Revised standards have been released for managing sovereign debt restructuring endorsed by the Paris Club of creditors and also the G20 including China. The IMF has also come up with some interesting proposals to introduce new terms into sovereign debt issuance, such as negative pledges, contingent repayments, extendable maturities etc.

All good initiatives – but we must always remember, sovereign debt is anything but risk free. Inevitably there will be more defaults and these will rebound on the banking sector both indirectly through downgrades and directly through losses on their sovereign exposures.

Banking Sector Reforms Key in Mitigating Covid-19 Related Downturn

Nine months since the start of the pandemic, we argue that despite increasing provisioning costs and declining net interest income, the banking sector is relatively better placed to withstand the potential economic fallout of Covid19 than it was the financial crisis of 2007-12.

Starting with **Capital Adequacy**, the most fundamental measure of a bank's ability to withstand stress, bank core equity tier one (CET1) ratios pre-crisis averaged 7.5% of risk weighted assets in Europe in 2007, but for GSIB's and other large banks the ratio was lower, at around 6%. Due to Basel III's reforms these ratios are today more likely to be at least 12%, and in many cases 14% and upwards.

Figure 1

Key Stress Test Assumptions 2018-19

	USA	EU	UK
National GDP fall	8%	8.3%	4.7%
Unemployment	10%	9.7%	9.2%
House price falls	25%	19%	33%
CRE price falls	35%	20%	41%
Equity price falls	50%	22%	50%

Complementing the much-improved capital ratios of the sector are the periodic stress tests performed by regulatory authorities in the USA, Europe and elsewhere. The objective of these annual exercises is to ensure that large banks can survive stressed environments whilst retaining minimum levels of capital. Examples of the key stress test assumptions are provided in Figure 1. The severity of these assumptions is often based upon the 2008-10 recessionary period. However, some variables, e.g. GDP growth and in some countries unemployment, look as though they will be quickly exceeded by the economic fallout resulting from Covid-19. In response to this weaker than expected environment, the sector appears in some cases to be taking prudent action to further buttress capital levels. For example, in the US & UK bank supervisors have restricted dividends and share buybacks for 2020.

To back up enhanced capital levels, **formal bank resolution regimes** have also been established in many parts of the world to facilitate orderly recapitalization or wind-down of failing firms. In Europe the Bank Resolution and Recovery Directives (1&2) and in the USA the Orderly Liquidation Authority section of the Dodd-Frank Act, provide resolution authorities with clearly defined powers to resolve failing firms whilst maintaining financial stability. In parallel resolution eligible liability requirements, (although not fully complete in many parts of the world, particularly for smaller firms) have been in place at a transitional level for globally systemic important banks (G-SIB's) since 2018. Such liabilities are likely to be ultimately at least equal to loss-absorbing capital for international and domestically systemically important firms, providing a clearly identified pool of liabilities to provide recapitalization in the event of failure.

Most commentators are agreed that **Asset Quality** is the most likely transmission method of the pandemic to bank solvency. The interruption of economic activity in Q2 caused recessions in many parts of the world that were off the scale of living memory, and in some cases centuries. Although Q3 often resulted in a healthy "bounce", the potential remains for economic distress to impose credit losses in a manner and on a scale not experienced previously, particularly where renewed and prolonged restrictions damage economic capacity permanently.

Starting with consumer debt, government support for laid-off workers and forbearance measures have so far cushioned the recession. This cannot continue ad infinitum though, and as these schemes are withdrawn from Q1 2021, increases in defaults are inevitable. The impact may be highly segmented though. Residential property prices are at record highs in many countries, and this may help soften the blow for lenders. Unsecured and lower-quality secured lending may well be the source of most losses in this sector.

For corporate lending, as ever in a downturn, the risks will lie in portfolio concentration and correlation. Banks heavily exposed to airlines, leisure, retail, and tourism may suffer disproportionally higher losses in their corporate lending than capital models predict. Commercial property looks even sicker than usual in a downturn, as the pandemic may have accelerated the decentralised offices and online retail rendering many prime city centre buildings obsolete. The level of government intervention in particular industries and the economies in general may be a critical driver of eventual credit losses in the banking sector.

One important factor currently directly influencing capital levels is the **recognition of loss provisions**. This can be highly variable across jurisdictions and individual firms. In Germany under IFRS 9 Deutsche Bank moved away from so-called "point in time" loss models to a more "through the cycle" view. This should avoid extreme volatility in its allowances and capital, but Deutsche still expects provisioning to be €2.0 billion in 2020 for a portfolio which performed strongly during the last recession.

In the USA, where pending accounting standards will require full lifetime provisioning, the sector provided $73 billion of losses in HY1 2020, although Q3 saw much lower levels of $5.4 billion. Ultimately, whether prudent, early recognition of losses or a more phased approach is appropriate in these unique circumstances depends upon whether Covid-19 is viewed as a temporary or more lasting impact upon economic output.

One of the challenges posed by the pandemic for **Management** has been the lack of availability of traditional channels of customer interaction such as branches or even call centres. One likely permanent outcome for the sector is that firms which had strategically embraced technology earlier,and were able to provide better service with staff working from home, are likely to win a lasting competitive advantage. This logic can also be applied to other technology-led initiatives in the sector such as cloud data storage, artificial intelligence, fraud, cyber-security, and operational resilience.

Another factor likely to lend greater stability to the banking system than the is the greater emphasis placed on **stable funding and liquidity**. The Basel III liquidity coverage ratio now requires all banks to hold sufficient high-quality liquid assets to withstand a 30-day stress including a complete lock-out of wholesale and currency funding. Whilst this has resulted in much greater levels of liquid assets, it has, along with the net stable funding ratio, dis-incentivised the use of short-term wholesale funding sources that were such a means of systemic transmission of the 2007-8 crisis. In place of the short-term wholesale funding banks have largely funded themselves with either more stable deposits or long-term wholesale sources, taking advantage of flatter yield curves.

Another reduction in **systemic risk** has occurred through the extensive re-regulation of over the counter (OTC) derivatives. Although central counterparties (CCP's) for derivatives existed in 2008, the requirement for plain vanilla contracts across interest and credit index trades means that their ability to "fire-break" counterparty defaults is now much more significant. For OTC contracts which are not centrally cleared, regulation of margin levels is similarly designed to protect bilateral counterparties much more effectively.

Despite these improvements in the structure of balance sheets, risk management and financial system architecture, concerns do remain about firm's **earnings** potential. Revenues thus far have held up relatively well, although provisioning levels have risen as described above. The largest long term-threat appears to be **market risk** arising from depressed levels of interest rates. US Treasury yields have halved from pre-pandemic levels, and Eurozone bond yield curves are negative yielding beyond the 10-year benchmark. The average exposure to a 1% fall in rates for large global banks is estimated to be less than 1% of CET1, but this could be as much as 10-15% on an economic value of equity basis where rates shift permanently lower.

However, the recent rise in UK Gilt yields in response to what appears to be a permanent post-pandemic structural deficit, provides a reminder of the risks of rapidly rising rates. Bank's exposure to rising rates are typically greater than falling, and are transmitted through FVOCI liquidity portfolios and cashflow hedging reserves. Defending a falling currency in the face of rising inflation could become very costly for a country's banking sector and would also feed into rising credit risk in the form of payment shock to retail and corporate borrowers. A falling currency could itself pose significant capital adequacy stresses where banks have significant overseas operations.

Covid19's effect on the financial sector is as yet unknown, and ultimately may be dependent upon the size of assistance that governments are willing (and able) to provide to their economies. Many uncertainties exist, not least the ability of banks to earn revenues and recapitalise in an environment where loss provisioning is driven upwards, and yield curves may become a long-term flatline.

However, the measures that we have outlined above to increase capital adequacy and liquidity, reduce systemic risk and improve resolvability can be argued to at least have "mended the roof whilst the sun shone", and leaves the sector as well placed as could be expected to face the uncertainties of 2020 and beyond.

Interesting links

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