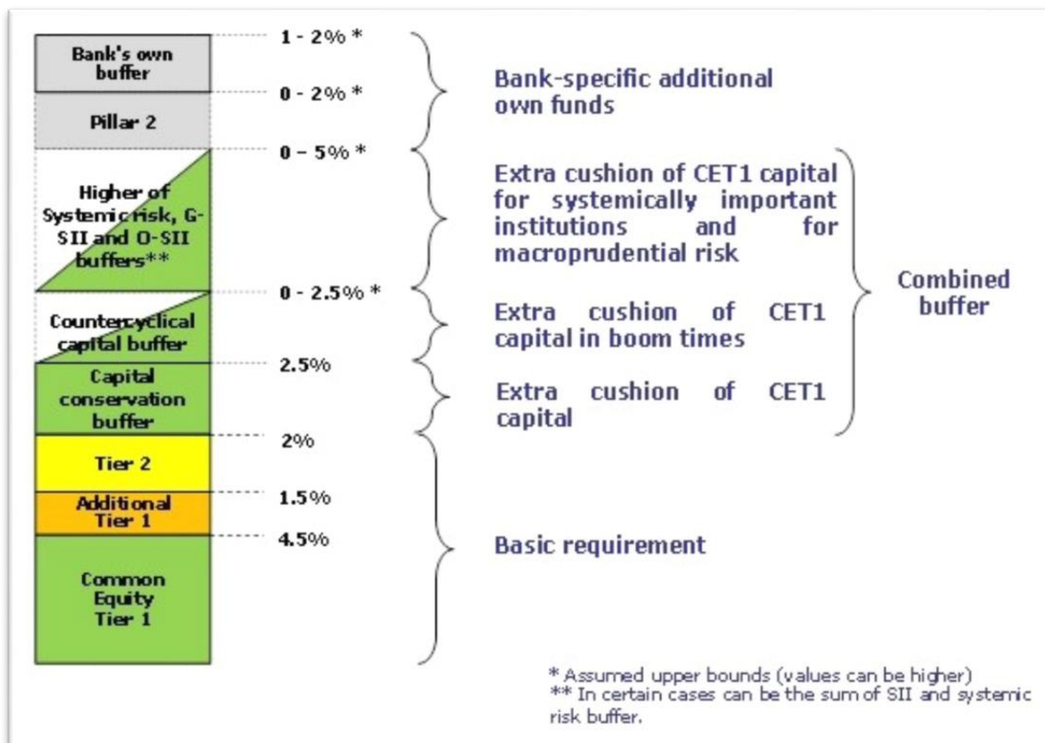
Assessing Bank Credit

15th July 2016

Our clients it seems, have positioned themselves carefully post referendum and are now in a financial environment typified by particularly cautious investment. However, perhaps surprising to some, equity markets, excluding Europe, have rallied which is reflected in the falls in short term volatility across those equity markets (for more information on this please see last week's Friday Night 'Lights). So for this week's piece, why not take a thrilling walk through the world of bank credit and how to assess the strength of a balance sheet in this confusing post-Brexit environment?

When initially assessing a credit, you are faced with a balance sheet numbering several hundred pages, with incredibly complex aspects. Breaking these down, it is important to understand the nature of credit within these institutions, and how the various different sections come together to form a financial institution. What happened during the crisis is pretty well known, banks continued to pay coupons on lower tier debt (when in effect, they should have deferred), what were perceived to be mildly risky assets were in fact highly toxic and a bank's ability to fund their illiquidity in the short term via the repo-market effectively disappeared – banks were bailed out, equity holders had their portfolios decimated, and now we're all partial owners of several financial institutions in the UK. Joy! Clearly something needed to change, so the regulators looked to address three things; (1) Capital coverage improvements, (2) reassessment of Risk Weighted Assets (RWA's) and (3) rules surrounding liquidity and sources of funding. What they came up with, as we know, is Basel III, detailed in the chart below *(source: EU Commission).*



Rates (bps)		
	Current	Week Chge
GBP 1yr	54.80	1.00
GBP 3yr	54.00	3.00
GBP 5yr	62.40	5.10

Equity Indices (%)		
FTSE 100	6637.1	1.22%
S&P 500	2168.38	2.70%
Nikkei 225	16497.85	9.21%
Eurostoxx 50	2954.06	4.53%

Currencies (%)		
GBPUSD	1.3297	2.63%

5yr Credit Spreads (bps)		
Citigroup	78.53	-8.21
Credit Suisse	145.45	-26.87
Deutsche	222.85	-22.33
GS	93.23	-9.81
HSBC	82.86	-15.37
JPM	57.84	-6.09
MS	91.74	-9.99

Commodities (%)		
Gold	1324.36	-2.30%
Oil	45.99	0.72%

3m Implied (vol pts)		
FTSE 100	14.12%	-3.81%
S&P 500	12.28%	-1.36%
Nikkei 225	23.84%	-1.71%
Eurostoxx 50	21.35%	-3.00%

5yr Implied (vol pts)		
FTSE 100	19.43%	-0.43%
S&P 500	21.53%	-0.52%
Nikkei 225	20.06%	-0.88%
Eurostoxx 50	19.85%	-0.58%

Source Bloomberg / Partner Banks
Data as at 15th July, 2.30pm

Indicative Autocall Levels – 6yr	
FTSE Flat, 65% EKIP	11.20%
FTSE 5% step, 65% EKIP	8.60%
FTSE/S&P 5% step, 60% EKIP	9.10%

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Banks were ordered to significantly increase CET1 and Tier 1 capital levels – from 2.5% to around 7% (though most are well above 10% now – this is especially important for Globally Systematically Important Banks). Furthermore, they were required to adjust their leverage ratios (average total assets divided by average total equity), ensuring they are not too highly indebted and take due consideration when assessing the value of OTC derivatives and counterparty risk.

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Banks have secured their balance sheet mostly through creating alternative forms of capital in the form of CoCos (contingent capital bonds which sit in the AT1 and Tier 2 parts of the balance sheet). In simple terms they act as insurance for a bank against their own balance sheet and are designed to reduce liabilities and increase equity during times of stress by converting your bond into shares in the company based on a trigger point where the bank falls below the minimum level of tier 1 capital. For an investor these are not dissimilar to writing a put; one receives payment upfront for owning potential future downside risk. Though they represent a potentially attractive investment due to higher yields (typically above 6% p.a. for a junior subordinated bond), as a direct consequence of their complexity the FCA have made it difficult for retail investors to purchase such securities.

So, were CET1 to fall below what Basel III would consider dangerous, a bank must address this – either by converting CoCos or by going to the PRA with a credible plan to stabilise the company (cutting dividends, reducing costs etc). Post-crisis the banks were also encouraged to sell off non-core businesses and reassess their lending criteria, including considerations such as whether they are regionally exposed to a certain property market or what their average loan to value for a mortgage is. Finally, the banks have been aggressively looking to redesign their corporate strategies to enable strong growth of retained earnings, thereby making them more stable in times of financial stress; this (like all "corporate strategies") has had mixed success and is very much dependent on the bank you look at.

Basel III took the approach of assigning different risk levels to different asset classes, for example US government debt had 0% risk weighting, whereas types of mortgage would have much higher risk weighting. The Risk-Weighted Assets are then plugged into a ratio formula as a denominator to determine a bank's solvency.

The focus of liquidity as part of the Basel III directive was to ensure the resilience of a bank's short-term requirements. This means ensuring a bank has an adequate amount of high-quality liquid assets that can service their needs in times of stress. One measure that was imposed for this was that of Liquidity Coverage Ratio (LCR), which assesses the highly liquid assets of a bank versus the cashflows over a 30-day period. The standard imposed from 2015 was coverage of at least 100%.

A bank's credit default swap (CDS) acts as a good indicator of the market's perception of the relative strength of the banks, taking all of the above and a number of other factors into consideration. Please see below for a comparison of the current levels *(source: Bloomberg, data as of 12th July 2016).*

	Bank															
	Credit Suisse	UBS	BNP	SG	DB	JPM	Citi	GS	MS	Wells Fargo	HSBC	Sant UK	Barclays	Lloyds	RBC	CIBC
Systematically Important	√	√	√	√	√	√	√	√	√	√	√	√	√	√	-	-
Credit Rating																
Fitch	A-	A+	A+	A	A-	A+	A	A	A	AA-	AA-	A	A	A+	AA	AA-
Moody	Baa3	A1	A1	A2	Baa2	A3	Baa1	A3	A3	A2	A1	Baa1	Baa3	Baa1	Aa3	Aa2
S&P	BBB+	A+	A	A	BBB+	A-	BBB+	BBB+	BBB+	A	A	A	BBB	BBB+	AA-	A
CDS																
Current 5yr CDS	151.07	70.05	80.09	78.68	221.84	58.58	79.10	96.55	94.33	50.98	87.83	83.16	125.16	107.50	-	-
1yr average CDS	108.68	64.00	79.18	83.15	138.31	75.93	92.83	100.35	97.45	58.44	87.70	72.35	91.59	75.58	-	-
3yr average CDS	82.00	60.69	80.09	91.52	99.99	69.74	83.57	95.75	92.39	51.26	70.96	60.69	82.66	74.80	-	-
Ratios																
CET1 Ratio (%)	11.40	14.50	10.90	10.90	11.10	11.60	12.10	13.60	15.40	10.70	11.90	11.60	11.40	13.00	10.60	10.80
Leverage Ratio (%)	3.30	5.30	4.00	4.00	3.50	5.92	5.49	6.63	5.04	6.62	5.00	4.00	4.50	4.80	4.30	3.90
Liquity Coverage Ratio (%)	-	128	124	137	119	-	112	>100	-		116	120	134	-	127	119
Supplementary Leverage Ratio (%)	-	-	-	-		6.50	7.10	5.90	5.80	7.70	-	-			-	

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