



2014

A Year of Challenge for the Banking Industry



Also in this issue

- Global Banking Standards: A Long and Stoney Road Ahead
- How Auditors Can Overcome the Strategic Challenges Posed by Basel III
- Debt: Does It Continue To Be There?
- Banking in Emerging Markets – Female Entrepreneurs and Financial Literacy
- Managing the Risks of Social Media
- Star Trek Banking – When Disaster Strikes!
- The Bank for International Settlements and Large Exposures

Debt: Does It Continue To Be There?

Author Flora Prieto, a senior risk management specialist based in Madrid, contributed this article, aimed to reflect on debt's role in the current economic environment.

Many voices worldwide over the last few months, are insisting on the need for recovering financial sector's capability for funding economy's growth. IMF papers, ECB reports or AFME roundtables are just some examples of this.

A quick glance to the latest Euro Area Bank Lending Survey (ECB, 2014) reveals the existence of a wide array of factors which explain debt's vanishing. The problem gets even more complex when taken into consideration the role played by the different participants in the debt chain. Applying the classical perspective of a supply-demand relationship, the movements on the supply side in response to more restrictive regulatory frameworks alongside changes seen in the traditional banking business model contributed towards pushing down the demand curve. As a result of all this, customers suffered from credit restrictions. The "contagion" effect to the rest of the economy was already served with the added element of the loss of faith in some of the market participants. Tactics that have always worked seem not to work any longer. Where does the problem lie?

Getting back to the survey mentioned above, it is worth mentioning the relevance that management aspects, external circumstances and derived effects, are playing in making it extremely difficult to get out of the crisis circle.

Banks acknowledge the tightening in their credit standards. However, as they explain, is not simply the consequence of downgrading customers' creditworthiness. Internal aspects associated to their costs of funds and access to markets' financing is resulting key for understanding the persistence in this bank's attitude. Also the external macroeconomic environment does not seem to have found its way up towards a

consolidated recovery. The worse consequence is the freezing effect on demand. A lower level of capital investments highly precludes the possibilities for further expansions of the activity over the long run. If accompanied by less available operating funds, the overall result is the movement towards a cash economy in which trade financing and credit policies have not much to say.

The list of Financial Soundness Indicators of the IMF includes as one of its categories the "Encouraged FSIs for Deposit Takers". Among the measures being monitored and updated on a quarterly basis are the Customer Deposits to total (non-interbank) Loans and the Spread between Lending and Deposit Rates. Considering the existing available data corresponding to EU countries, it can be observed that with the exception of some heavily service oriented economies like Luxembourg or Malta, the rest follow a trend where the level of deposits are lower than the loans. A similar pattern of behavior is being displayed by the BRICS. However, when looking at the leading developed economies of Japan and the US, deposits exceed the amount of loans, approximately by one third. On the other hand, spreads show a wide range of fluctuations within each of the analyzed group of countries. The highest values would correspond to some of the BRICS. Brazil with 852 basis points and Russia with 392 are examples of this. In Europe and developed economies, with the exception of just a few countries facing serious financial difficulties like Greece or Romania, values fluctuate between 130 and 300 basis points.

Shifting the analysis towards complementary banking activity sources, the indicators of Gross Assets and Liabilities Position in Financial Derivatives to Capital show a higher importance of the latter respect to the first for most of the analyzed

countries, with the UK and Ireland the ones with higher proportions of capital invested in this type of instruments.

How are markets behaving in respect to debt? In terms of issuance, available data seems to confirm that 2013 has been a consolidating year for the recovery trend started one year earlier by the corporate bond market. However, some aspects are worth noting. On one hand, the significant geographical differences which can be observed across the different world regions. On the other hand, the increasing importance of riskier debt products likes high-yield bonds.

A comparison of research reports referred to the same period of time and elaborated by similar institutions, present in different parts of the world like the Association for Financial Markets in Europe (AFME), Asian Securities Industry and Financial Markets Association (ASIFMA) and the Securities Industry and Financial Markets Association (SIFMA) allows one to see the existence of relevant differences. Focusing on the issuance, investment grade bonds continue to represent the most important part of the market. However, as mentioned above, high-yield ones are becoming more present. While in Asia they roughly represent around 9% of the total volume issued, in the US, approximately one-fourth falls within this category. In Europe, its acceptance continues to increase which results in the possibility to find issuers from all countries, including the emerging markets of the former Eastern Europe. In the Asian market, roughly one-third of the total is sovereign high-yield. Asian securities' spreads are slightly higher than US and European ones for investment grade bonds, getting narrower, almost equal for high-yield corporate. In terms of maturity, Asia continues to be highly receptive towards perpetual bonds, the bulk of the issuances would pursue time horizons below five years

Debt: Does It Continue To Be There?

in opposition to European ones with a tenor between five and seven years.

If the attention is being shifted towards the issuers, telecoms lead the European figures followed by finance firms. In the Asian market, this secondary place corresponds to real estate companies. Other types of industries prefer other debt alternatives. Thus, if considering leveraged loans, it would be healthcare, professional services and transportation companies the main issuers in Europe. This is a market that on a global basis, more than tripled the volume of high-yield bonds. As with bonds, it has the US as the most important originator.

Roughly 80% of the high-yield bonds' issuance proceeds in Europe go to repayment and refinancing of debt and general corporate purposes. This impacts, negatively, on a company's financing costs, deteriorating its margins while making it necessary to postpone decisions on investment plans and possible further expansions.

This situation results more understandable when the picture gets broader and banks funding difficulties are being analyzed. The ECB survey highlights the negative consequences that the sovereign debt crisis is having

on bank's funding conditions and on their willingness to grant loans.

The above mentioned data confirms that corporations, markets and investors continue to be interested in debt as a financing alternative. The problem lies on the fact that access to these funds through financial markets are very expensive, in terms of all the associated transaction costs it entails. Furthermore, they do not have enough capacity as for satisfying most of the company's needs. The first aspect precludes SMEs from the possibility of having access to this financing alternative as they do not have neither enough resources for spending on this nor a recognized creditworthiness. The second is, partly the consequence of the limited access in terms of participants to these markets. They were not created with the purpose of being the sole financing provider.

Everything related to banks' funding seems to worsen. The ECB survey shows deterioration in both retail and wholesale funding over the last quarter of 2013, mainly due to increasing difficulties when dealing with short-term instruments like deposits, money markets and debt securities. This imbalanced situation is seriously affecting financial institutions, making it extremely difficult for them the

recovery. Customers are willing to borrow; they need these funds, in order to put new ideas to work pushing the economy forward. On the bank's perspective, they need to get over funding difficulties for moving into a position in which it would be possible to generate new business.

Up to now, economic crisis characterized themselves by being one-time events that could last a longer or shorter period, with a cyclical character as they show up after a certain number of years, but during which, economic agents had to struggle mostly with restrictive economic conditions. Even when, on some occasions, some firms redefined their business as a way for giving answer to the new environment, this was always done as an outwards process, without affecting the most basic concepts of their business model.

The current crisis seems to be more of a circle type. The challenge for banks seems to be, first in transforming it into a linear one, so that new advances can start to take place.

The author invites your comments via email to JK@riskrewardlimited.com

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