DURA CAPITAL

Counterparty Risk

When considering investing in any Structured Investment Plan, the first consideration should be the Issuer of the underlying securities and their creditworthiness over the life of the investment. Ultimately you are lending money to a financial institution and should be comfortable that the bank will be around to pay you back, in some cases, in up to 7 years' time.

Whilst credit risk is a source of return in your investment, it is also a source of risk. As we will explain, the return is very low currently for a number of reasons, therefore it makes sense to reduce the risk as much as possible through selecting banks with the highest ratings and strongest balance sheets.

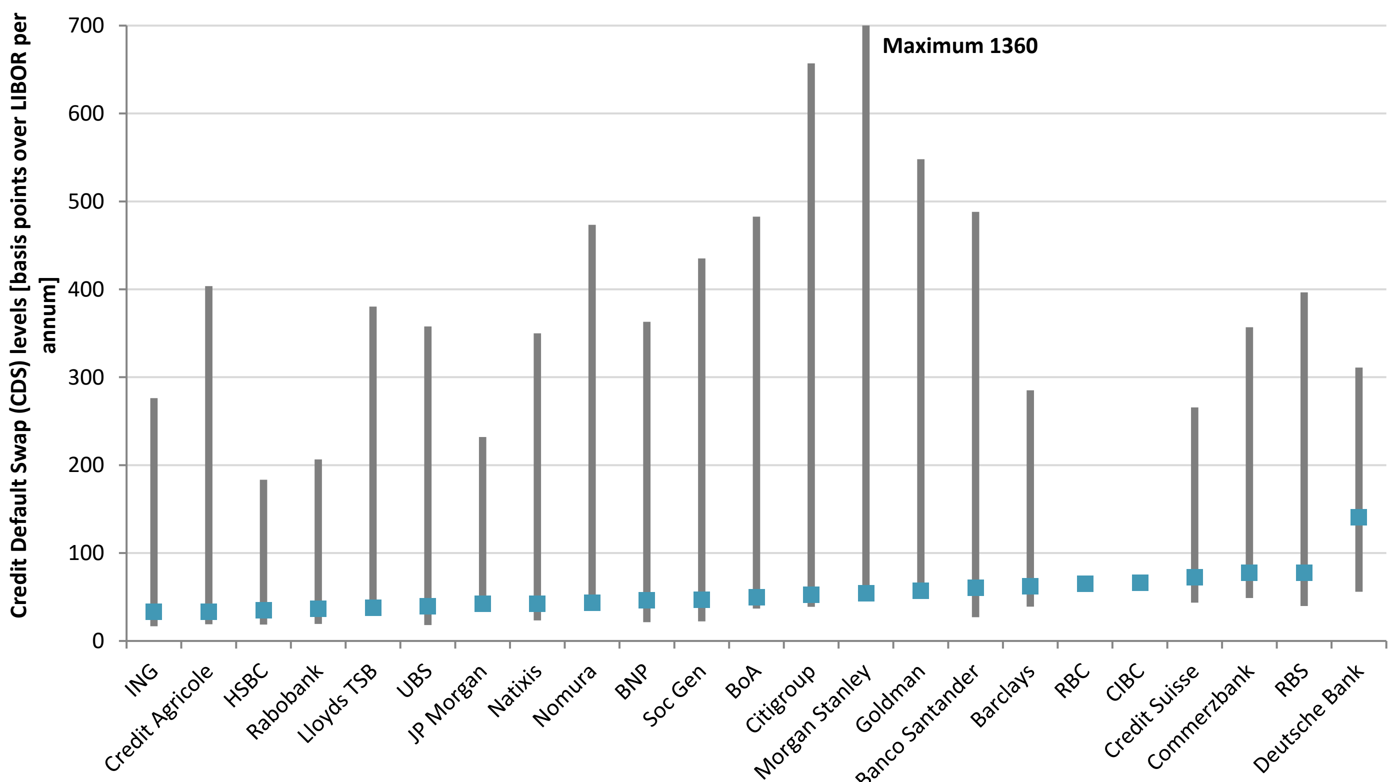
Prior to the financial crisis, only minor attention was given to bank credit risk. These monolithic institutions were considered risk-free and certainly too big to fail… Lehmans put paid to the notion in September 2008 and, despite stress in the mortgage securities that were largely blamed for blowing huge holes in bank balance sheets starting in 2006, the Lehmans default is widely acknowledged as the poster child of the Great Financial Crisis.

It has been 10 years since Lehmans defaulted and a plethora of other financial institutions were bailed out through a combination of some or all of the following; borrowing cheap money, forced recapitalisation by private or public sector monies, mergers and government guarantees of deposits and bank liabilities.

Regulation across the globe followed to ensure that banks de-levered and cannot pose the systemic risk to their national economies that was witnessed in the following years, particularly in Europe. Dodd-Franck and the Volcker rule in the US and Mifid II, EMIR, MIFIR and Basel III in Europe were all regulations designed in part as a response to the crisis. Governments, legislatures and finance ministers empowered their regulators to act on a grand scale. The Financial Stability Board, which monitors financial institutions across the G20 countries, highlighted four core elements of financial stability regulation. The first, and arguably most successful, of the principles was 'making financial institutions more resilient' particularly through bank capital regulations.

So how successful has the transformation of bank balance sheets and regulation been?

In short, from a bondholder point of view, they have been very successful… using a standardised market-based measure of bank credit risk (CDS), we can see that credit risk across global banks, almost without exception, are trading at or close to their historical lows since 2008, implying there is little concern of credit risk.



In addition, Banks are subject to annual stress tests and even under the most stressed scenarios, in excess of what we witnessed last time round, very few have failed. In the rare event of a fail or marginal pass, plans must be submitted to their national regulator to resolve the fail with a viable plan in place to increase capital.

How banks have achieved this and a framework that can be used for a bottom-up fundamental analysis of balance sheet strength might include, but not limited to, some of the following measures;

- Capital – like the equity in your house, a bank's capital level is a measure of the losses that can be incurred before they are considered insolvent. Unlike a house, a bank cannot go into negative equity and must keep their capital levels at a minimum level as established under the Basle III framework. In short, banks have issued a huge amount of, and better quality, capital.
- Funding – a major weakness of banks before the Financial Crisis was over-reliance on wholesale funding; a little like living permanently in your overdraft, which can be fine as long as you keep getting paid each month and are able to clear it or your overdraft rates don't increase significantly. However, if there is a 'credit crunch' or borrowing rates increase significantly, this is an unsustainable model and banks have reduced their reliance on wholesale funding.
- Asset Quality – almost universally, banks have reduced the size of their balance sheets by selling non-core assets and also underperforming or non-performing assets.

A simplistic analysis of the bank's balance sheet, which gives a snapshot of its financial strength, highlights the direction of travel since the GFC;

1. Total Assets – increased
2. Total Liabilities – decreased
3. Equity - increased

Here at Dura Capital, we spend a lot of time looking at the fundamental balance sheet strength of our issuing banks. For the reasons above, whilst we are happy with the level of credit risk inherent in these type of investments, you should be mindful that this can change over time. However, we are always looking out for warning signals or Issuer specific news which may change the picture. In addition, our Plans have focussed on Global Systemically Important Banks (G-SIBs.) These are the banks that the Financial Stability Board (FSB) have deemed globally systemic and, due to their interconnectedness, must hold additional loss-absorbing capital, which is music to a bondholders ear.

Whilst increasing regulation and de-leveraging haven't necessarily been a positive equity story, from the credit side, we are happy to see increased amounts of capital, less reliance on wholesale funding and improved asset quality. So what warning signs should you be looking out for? A deterioration in those measures should be closely watched and could cause concerns. Additionally, we will be closely watching Trump's rhetoric around 'peak' regulation and relaxing some of the post-crisis measures as these invariably lead to imbalances. Just as credit spreads have converged in the era of monetary easing, it is worth bearing in mind that the reversal could cause spreads to diverge on the path to normalisation. Whilst the business/credit cycle inevitably will turn, we can't see any short-term risks that would mean the next crisis is a liquidity driven financial crisis.

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