Are Systemically Important Banks Junk Credits?

Absent bailouts, large global banks are non-investment grade credits, according to empirical data.

Thursday, July 24, 2014 , By Joe Pimbley

Print | Order | Email this Story | ShareThis ShareThis

A great challenge for bank credit analysts is to figure out the degree to which banks rely on "extraordinary support" (a euphemism for "bailout") from their governments.

To understand how a bank's leverage, asset volatility and other financial, operational and economic characteristics impact its estimated default likelihood, a bond investor may build a brilliant quantitative model. However, there's a final overlay that is vexing: what is the probability that a government will step in to make creditors whole if the bank fails?

As with almost all such investment-analysis questions, there is no definite, unambiguous answer. But a September 2013 research report from *Fitch Ratings* (see "The Evolving Dynamics of Support for Banks") provides a fascinating observation.

For the period 1990-2012, Fitch assessed both the default rate and the failure rate for "senior creditors of systemically important" global banks. The five-year cumulative default rate in the period (1.15%) is six times lower than the failure rate (6.95%). Fitch defines failure as "defaulted or would … have defaulted without extraordinary support."

A quantitative model builder might be pleased with this historical data point. She will use her financials-based risk model to estimate failure rate and then multiply by a new "no-bailout" parameter of one-sixth (the Fitch result) to get the model's estimated default probability. This approach is feasible, but we're struck by a different observation.

Stepping outside the model-building exercise, the five-year failure rate of 6.95% (call it 7%) is striking. Referencing Fitch's Default Study of 2012 (see table 9 of the "Fitch Ratings Global Corporate Finance 2012 Transition and Default Study"), the Global Corporate Finance Average Cumulative Default Rate for double-B rated entities is 6.91% (call that 7%, also).

Therefore, in the absence of "extraordinary support," the world's systemically important banks behave like junk credits. At least, this is the blended effect of the Fitch universe for the period 1990-2012. Neither qualification, though, is disquieting. The universe is large and the 23-year time period is long and indicative of recent history.

The Junk Debate

To our knowledge, the dominant rating agencies do not assign underlying bank ratings (such as "bank financial strength ratings") that are non-investment grade. For example, of the 28 global systemically important banks Fitch lists in Appendix 4 of its September 2013 report, only the Bank of China receives a "junk viability rating."

Consequently, the rating agencies likely disagree with the characterization that "systemically important global banks are junk," absent government support. But we appreciate the Fitch study precisely because it shows observed data

Editor's Choice

A weekly selection of insightful risk management articles and resources

- **Are Systemically Important Banks Junk Credits?**
- **University of Florida's Flannery Named Head of SEC's Risk Division**
- **The Case for Managed Services in Risk Management**
- **Asset Managers Awaken to Risk-Based Regulation**

Risk Management e-Journal

The Risk Management e-Journal publishes paper abstracts on the topics that matter most to risk professionals. See what your risk manager colleagues are reading about today.

View

Get Free Updates on the Dodd-Frank Act

Register for Morrison & Foerster's FrankNDodd service to receive Daily News Alerts on the Dodd-Frank Act, gain access to regulatory highlights and commentary, and use the exclusive FrankNDodd Tracker tool.

Subscribe

Advertisement

Joe Pimbley

rather than just potentially optimistic models and judgment. We're not aware of any alternative historical studies of this sort. (If such studies exist, please tell us!)

Of course, this question matters greatly to bank regulators, investors and taxpayers, as well as to rating agencies. The world is now tightening prudential regulation by, for example, elevating capital requirements, pondering liquidity enhancements, considering a maximum leverage ratio (absent risk weighting) and forcing central clearing of derivatives.

Do regulators and the broader community agree that the "starting point" of systemically important global bank credit quality is junk? Or, as I suspect, is this point contentious? We need discussion and debate!

Our view is that the Fitch study is critically important. It deserves much wider attention and acclaim. Like a published scientific result, the world needs other rating agencies, bank regulators and academics to perform similar studies with other data sources to validate or dispute the finding that "banks are junk" without government support.

Joe Pimbley is a financial consultant in his role as Principal of Maxwell Consulting, LLC. His expertise includes enterprise risk management, structured products, derivatives, investment underwriting, training and quantitative modeling.

GARP® 2006-2014 Global Association of Risk Professionals. All Rights Reserved