Icelandic Banks: Sitting On The CDS Volcano

Summary:

As Glitnir’s CDS soared through 1,000 bps last week, we take another look at the reasons why the market seems so worried about Icelandic banks.

The banks’ reliance on wholesale foreign currency funding is their Achilles heel, and their profitability will come under pressure in 2008, but the CDS reaction smacks of panic that is not evident in the banks’ share prices.

We also look at the prospects for central bank support if needed.

This week saw Glitnir’s 5-year senior CDS erupt through the 1,000 bps barrier, with Kaupthing in close pursuit. This makes the Icelandic banks the widest financials in the CDS market – wider than the US monolines, wider than CIT and wider than Kazkommertsbank and Bank TuranAlem. In theory, this implies a high risk of default, although the oft-quoted assumption of a relationship between CDS and default probability is meaningless in these illiquid market conditions. These levels do, however, imply that the market is more worried about the Icelandic banks than almost any other financial institution. And yet their share prices have rallied in recent days and have been fairly buoyant this year, even though shareholders would probably have most to lose in a bank failure or bail-out.

Having been among the sternest critics of Icelandic banks in the past two years, we now find ourselves in the unaccustomed position of defending them. As we have said previously, we still think they are higher risk than other single-A rated European banks, but not to the extent implied by CDS spreads. We sense a general bafflement as to why spreads have continued to push so wide, from the banks themselves as well as from traders and investors, but the weakness seems entrenched, and there is no sign yet that anyone sees this as an opportunity to sell protection.

Do CDS matter?

We have reiterated our views on the fundamentals of the banks in previous articles this year (see Icelandic Banks FY07: Heads You Lose, Tails You Lose). There is little more to say, as the spread widening has been based on the same old vague fears rather than on specific news or events. The question is: does it matter to the Icelandic banks at what level their CDS are trading? In practical terms, probably not much in the short term, but it does damage the wider perception of the banks in the longer term, and that is a bigger threat. As they have shown in recent weeks, they have been able to tap the private placement market at levels well inside their CDS, although funding has nonetheless become very expensive. However, we presume that some investors might be more reluctant to buy bonds if hedging is so expensive. Also, CDS levels are bound to have some impact on the spreads of existing floating rate bonds. We examine below the implications of current levels for CDS, share prices and credit ratings, and consider some of the reasons for the CDS weakness. The charts show trends in 5-year senior CDS and share prices for each of the banks since the start of the year, showing the steep rise in CDS levels and the more stable development in share prices.

CDS. The CDS market was once seen as the benchmark for credit analysis, offering a purer view of credit quality than bonds, which were seen as blemished by technical and trading quirks. No longer. The lack of liquidity in single name CDS makes the quotes unreliable, exemplified by substantial intra-day volatility and wide bid/offer spreads. It is difficult to find quotes for most Nordic banks, and we suspect the illiquidity in Icelandic bank CDS is more marked than for most names. Also, Icelandic banks were included in many CDO structures because of the comparatively high yield they offered compared with their credit ratings, and it is probable that the CDO unwind is affecting their spreads more than most. In short, we do not think CDS spreads necessarily reflect the general market view and should not be seen as an indication of default probability.
Share prices. It is unusual for share prices and CDS to move in opposite directions, especially when there appears to be a genuine fear of a bank failure. After all, as we have seen with Northern Rock and Bear Stearns, bondholders are normally better placed than shareholders in bank bail-outs. Unlike the CDS market, the stock market does not seem to be factoring in imminent problems – the banks are trading on P/E ratios of more than 8x and P/BV ratios of over 1.5x. However, we suspect the Icelandic stock market is, in common with CDS, not necessarily a reliable indicator in these market conditions. The involvement of foreign shareholders is still small, and a large portion of banks' shares are owned by a small number of Icelandic investment companies.

Credit ratings. Ratings have been falling, although they remain in the single-A range. Moody's recently downgraded Kaupthing from 'Aa3' to 'A1' and Glitnir and Landsbanki from 'Aa3' to 'A2', completing a helter-skelter journey which saw the banks handed triple-A ratings for a brief and surreal period last year. However, Moody's seems more concerned about the impact of market conditions on the banks' earnings and asset quality than their funding and liquidity arrangements, which it regards as 'sound'. Fitch has consistently rated the banks 'A'. S&P has placed its 'A-' rating of Glitnir on negative watch - management is probably now regretting being the only Icelandic bank to apply for a rating from S&P. Single-A debt ratings and financial strength ratings of C- from Moody's and B/C from Fitch do not suggest that the rating agencies think the banks are in serious trouble, but the banks' CDS have effectively been ignoring the ratings for some time. Of course, a worry for investors is that Northern Rock and Bear Stearns were also quite highly rated when they had to be bailed out.

Fundamentals

According to the latest financial reports from the three Icelandic banks, they were reasonably profitable, had strong asset quality ratios and reported high regulatory capital ratios in 2007 (see Icelandic Banks FY07: Heads You Lose, Tails You Lose). As we have pointed out before, however, there are caveats about all these areas. The banks' profitability has historically been quite dependent on trading gains (with the exception of Glitnir), particularly on equity holdings, and on capital markets business; very strong balance sheet growth could be storing up asset quality problems for the future, particularly in areas related to commercial property and acquisition finance; and underlying capital ratios are weaker taking into account the high proportions of hybrid capital in Tier 1 and the banks’ relatively large equity investments. However, while earnings will inevitably come under pressure this year, we do not see these weaknesses as serious enough to justify the extent of the CDS widening. Glitnir and Landsbank have virtually no US sub-prime or structured credit exposure, and Kaupthing's involvement is relatively small. This leaves fears over funding and liquidity, as well as questions over potential support if needed, as the likely main factors.

Funding and liquidity

Mid-sized banks with small deposit bases that are heavily reliant on market funding have been a particular target for credit markets recently, and the Icelandic banks are the most obvious example. Funding and liquidity was a major concern of ours when we first started covering the Icelandic banks at the beginning of 2006. Since then, they have increased liquid assets, diversified their funding and extended maturities, but it has not saved them from worsening market sentiment. All three banks have liquidity policies that ensure liquid assets are sufficient to cover debt maturing over at least the next 12 months, but the market is more interested in their ability to access funding, including rolling over interbank and money market lines. As mentioned above, the banks have been able to issue in the private placement market in the US this year (see (WW) Kaupthing Bank: Funding News), but this has failed to reassure investors. The banks face an increase in debt redemptions in 2009, but Kaupthing says it has already pre-funded its debt maturing in 2008, Landsbanki's debt repayments for FY08 are relatively modest at €749 million, and Glitnir said this month that it needs to finance further redemption of €2.45 billion for the group this year (including, we estimate, around €2 billion for the parent bank). While, in common with most banks, funding conditions are tough, there seems to be little here to justify the panic on the CDS markets.

Why Glitnir has been affected more than the other two banks in recent days – its CDS are now wider than Kaupthing’s – is difficult to explain. It is probably a mixture of factors, including the problems that have been experienced by its major shareholder, FL Group, the fact that its
deposit ratios are the lowest of the three banks, including a deposits/loans ratio at end-2007 of 37% and a deposits/total funding ratio of 29%, and its higher redemptions of long-term debt in 2008. On the other hand, its more conventional business profile, with less reliance on capital markets and investment banking, which used to mean it traded tighter than either Kaupthing or Landsbanki, has been ignored in recent months.

Support

One question we have consistently raised in our analysis of the banking sector is the ability of the Icelandic authorities to support the banks if they got into difficulties. We have no doubts about their willingness to do so. We returned to this theme in a recent article about global systemic risk (see From A Point of UnBearable Strain, Where Do We Go From Here?). It would be difficult for Iceland's central bank, with its international reserves of only $2.6 billion, to overcome a full-blown crisis in Iceland's banks if it were operating alone. By our calculations, the combined assets of the three major Icelandic banks are around nine times bigger than Iceland's GDP, a much higher ratio than for other European countries. But Iceland is a member of the informal club of Nordic Central banks, a group whose combined international reserves total $129.4 billion, and most of whose members are not part of the Eurosystem and still retain their monetary tools. These five central banks have already signed a Memorandum of Understanding (dated June 2003) for a cooperative response to a liquidity crisis at one or more Nordic banks. The MoU makes clear that the central banks will not intervene to prop up an insolvent bank, but a bank facing liquidity problems could be offered support from the group. On 28 March, Iceland's Prime Minister touched on the question of bank support in his annual address to the Central Bank of Iceland. He said, "The net debt of the Treasury is now quite small or almost nonexistent, a fact that few western nations can boast of. This means that the Treasury is in a strong position and can therefore borrow sizeable amounts if necessary. There is no doubt that the Treasury and the Central Bank could provide assistance if a serious situation were to emerge in the banking system. I have repeatedly been asked about this by foreign parties in recent weeks and I have always responded that the Icelandic authorities would in such circumstances not hesitate to resort to the same measures as responsible authorities in other countries. I am restating this now".