

# Weak credit culture in the Russian rouble bond market

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## WHAT IS A “CREDIT CULTURE”?

STANDARD  
& POORS

RATINGS DIRECT

RESEARCH

### Russia's Ruble Bond Market Cries Out for a Stronger Credit Culture

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← *Is this only a mispricing of risk by investors?*

Although the ruble bond market has added a new dimension to Russia's capital markets, it still displays the characteristics of an underdeveloped market. Specifically, credit risk is not well differentiated on the basis of good fundamental analysis and refinancing risk is high due to the very short maturity characteristics of debt issues. Therefore, until risk is better understood and managed by investors, the smooth functioning of the market will remain particularly vulnerable to unexpected defaults and other events that shake market confidence.

*“A credit culture is rooted in corporate attitudes, philosophies, traditions, and standards that require administrative underpinnings. The role of a credit culture is to create a risk management climate that will foster good banking...” – Henry Mueller, Chief Lending Officer at Citicorp*

*“Credit culture is how we do things around here” – John McKinley and John Barnickman, Strategic Credit Risk Management, 1994*

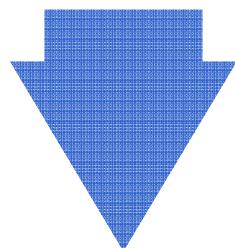
*«A bank's credit culture is the unique combination of policies, practices, experience, and management attitudes that defines the lending environment and determines the lending behavior acceptable to the bank» – Ann Barr Taylor and R.P. McWhorter, The Journal of Commercial Lending*

## PROPOSED DEFINITION OF A “CREDIT CULTURE”

Credit culture – is a combination of formal and informal rules, traditions, practices, philosophy, style and manners which borrowers (issuers) and lenders (investors) stick to

## KEY WEAKNESSES OF THE CREDIT CULTURE IN THE ROUBLE BOND MARKET

1. Poor disclosure standards and practices
2. Weak bond structures. No covenants. Frequent breach of “promises”
3. Overpricing of risk, particularly in the 3<sup>rd</sup> tier



**This environment is very relaxing for issuers and very uncomfortable for investors...**

## **POOR DISCLOSURE STANDARDS AND PRACTICES**

- 1. Investors are increasingly offered to look at unaudited “management accounts” of issuers, which nobody can be held responsible for**
- 2. Bonds are often structured as issues from ABC-Finance SPVs with guarantees from operating companies. The law requires regular disclosure only from the issuer, not from the guarantors**
- 3. Violation of disclosure requirements may in the worst case scenario result only in a small penalty charge by the regulator**

## WEAK BOND STRUCTURES, LACK OF COVENANTS

**1. The rouble bond issuers can do whatever they want with no effective control from bondholders or punishment. In particular, issuers are allowed:**

- to dispose/pledge operating assets*
- to relocate cash flows*
- to increase leverage above levels indicated as targets*
- to liquidate guarantors*

**Current legal framework makes it impossible to build in financial covenants**

**Investors have to believe to the intentions which are declared by the management in the pre-issue “information memorandums”**

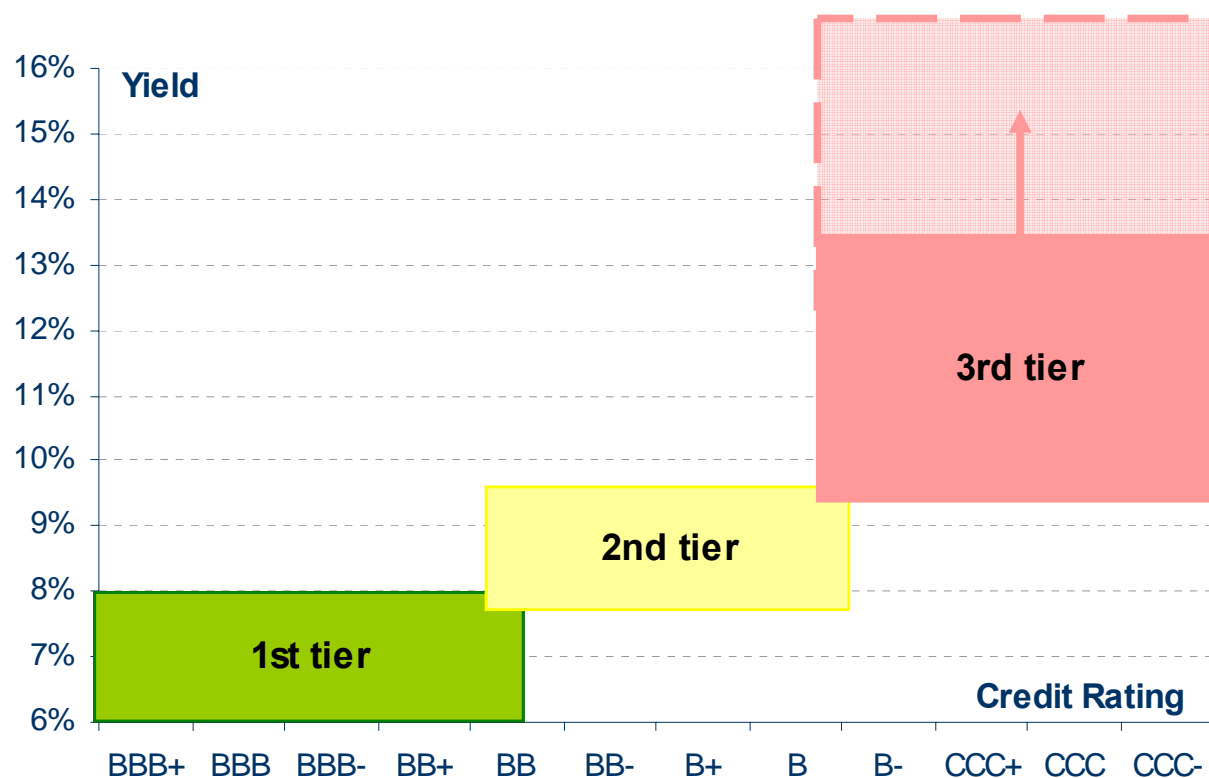
**In practice issuers often forget about their “promises”**

**EXAMPLE: an issuer used the bond proceeds to play with its own shares while according to the “information memorandum” he intended to buy new operating assets**

**2. A combination of issuer + guarantors sometimes doesn't give bondholders exposure to key assets or cash flows in the group**

## INADEQUATE PRICING OF RISK

1. The fact that some issuers borrow secured loans at rates that are comparable or higher than those on bonds signals overpricing of risk by bondholders
2. The yield range in the 3<sup>rd</sup> tier (where junk issuers belong to) is only around 450bp (9.5%-14.0%). We believe it should be much wider to fully reflect the difference in the credit risk profiles. Potentially we should talk about more than just three tiers of issuers



Rating	Probability of default, %		
	1 <sup>st</sup> year	2 <sup>nd</sup> year	3 <sup>rd</sup> year
<b>BBB</b>	0.27	0.81	1.4
<b>BB</b>	1.2	3.71	6.86
<b>B</b>	5.91	13.6	20.55
<b>CCC/C</b>	30.41	40.02	46.13

*Source: Standard & Poor's Global Corporate Default Study, 2005*



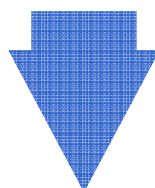
## WHAT ARE THE REASONS BEHIND WEAK CREDIT CULTURE?

1. Greed. Banks often focus on short-term targets (volumes, rankings) at the expense of longer-term sustainability and reputation
2. Inefficient risk management practices
3. Regulatory loopholes
4. Insufficient analytical skills
5. “Past dependence”

## FOCUS OF BANKS ON SHORT-TERM TARGETS

### 7 reasons why banks bring weak issuers to the market and price them below “fair yield”:

1. New banks view the arranging/underwriting as an attractive business, they want to enter, even by picking up tough mandates from “difficult issuers”
2. Arranger/underwriter rankings are important for the franchise
3. Issuer often promises other mandates and businesses (IPO, transfer of accounts, etc.)
4. «If we don't do it, our competitors will do it»
5. «Who said that the issuer is bad? The market appears to be able to digest really weird names. Also, there were yet no real corporate bond defaults»
6. «We have loan exposure, let's transfer it into a bond exposure and sell some of that»
7. «Bonuses are dependent on volumes, not the quality of names we issue»



**In a non-cooperative game banks are loosing this market to issuers**

## «INEFFICIENT» RISK MANAGEMENT PRACTICES

Limits on bonds don't always specify the minimum yield which could compensate the risk of getting exposure to these bonds

## REGULATION: «GIVE US COVENANTS!»

We are not suggesting strict regulation, we strongly believe in the self-regulatory abilities of the market!

How could the regulator help?

- ✓ Introduce framework which would allow to build in covenants. This could help resolve many problems
- ✓ While there are no covenants, disclosure requirements should be adjusted
- ✓ “Weird” and unnecessary requirements should be removed (e.g. issuers younger than 3 years cannot issue without guarantors)

## INSUFFICIENT ANALYTICAL SKILLS

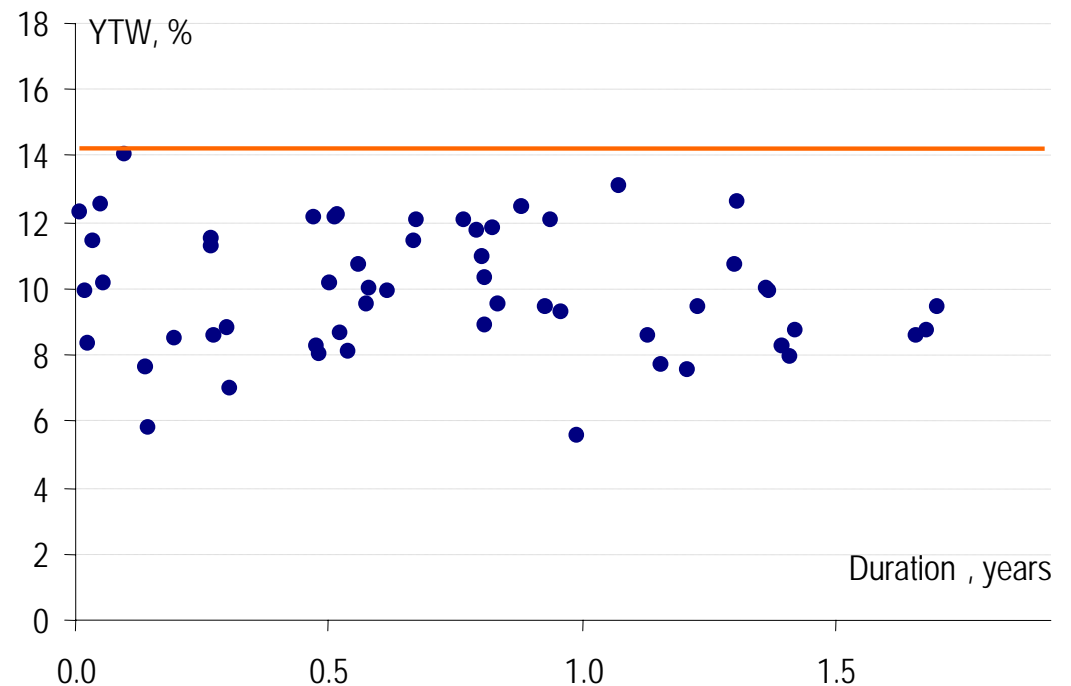
1. Investors study the past and don't do enough of forward-looking analysis
2. Investors often ignore the fact that bonds are unsecured debt
3. Poor understanding on how to analyse complicated corporate groups (weak subsidiary with a strong parent, strong subsidiary with a weak parent, etc.)

**Why? Because the market is still young and there were virtually no defaults post-1998**

## PAST DEPENDENCE

- ✓ The position of each new spot on the yield/duration map is dependent on the positions of outstanding bonds
- ✓ A potential move of a certain asset class up the yield scale will result into mark-to-market losses, which means investors will be unwilling to allow that
- ✓ Still, from time to time we are seeing how the market is adjusting upwards its understanding of fair yield on a given issuer

### Example: rouble bond universe of Russian industrial corporates (ex metals&mining)



## HOW DANGEROUS IS TO HAVE A WEAK CREDIT CULTURE?

1. Investors may incur financial losses as they are receiving inadequate compensation for risk
2. Reputation of investment banks may suffer
3. Regulator may “overreact”

### Stress-scenario could be triggered by:

- ✓ A prolonged rise in the cost of rouble liquidity
- ✓ A turnaround of the economy
- ✓ Tightening of risk-management in the largest banks



However, we don't expect the market to collapse following a series of defaults as in our view only about 15% of the issues outstanding are severely overpriced (30-50% of the 3<sup>rd</sup> tier), while the bulk of 1<sup>st</sup> and 2<sup>nd</sup> tier represents names with solid credit profiles

## WILL LIBERALIZATION AND ARRIVAL OF FOREIGN INVESTORS HELP?

**Not yet:**

- ✓ **Subsidiaries of foreign banks don't appear to be much smarter than Russian colleagues**
- ✓ **Truly smart non-residents mention weak bond structures, etc. but they are hardly heard by the market**
- ✓ **Foreign investors tend to focus on "healthier" 1-2 tiers**
- ✓ **Overall non-residents have also relaxed their attention to risk following very successful years in the corporate bond segment of Emerging Markets**





## WHAT ELSE CAN HELP IMPROVE OUR CREDIT CULTURE?

- ✓ Defaults? Obviously yes
- ✓ Increased number of smart investors, including non-residents? Yes
- ✓ Progress in tightening risk management at each individual investor? Potentially
- ✓ «Cooperative game» played by banks to explain issuers their risk is worth more and they should respect investors? Yes. But is it possible to create a “coalition of banks” for the sake of improvement of credit culture?

# THANK YOU FOR YOUR ATTENTION!

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