Clydesdale and Yorkshire Bank – All dressed up and nowhere to go?

When the banking Rating Agencies look at banks in order to give or review a credit rating, they are looking for a combination of stability, strength (in other words good capitalisation and liquidity), an external environment that is also stable and strong, support, either from a parent or government, and profitability, which goes hand in hand with a meaningful business plan.

Clydesdale Bank (we include Yorkshire Bank as they share the same balance sheet) is currently rated BBB+ by Standard and Poors, and Baa2 by Moodys, and it sits with a 'negative outlook' from the latter. These ratings are the thinnest shade above the lowest investment grade.

The significance of being above the investment grade line rather than below it is that investment funds, pensions funds, and tracker funds can buy the stocks and hold them. If a credit rating falls below investment grade for many investors this results in an automatic sale ticket; they can not longer hold onto the shares and are forced to sell them.

Clydesdale had a better financial year in 2013, and early signs for this year are that its recovery is gaining hold, as loan delinquency rates decline, and the broader economy picks up. 2013 was helped by the transfer of the £5.6bn commercial loan book (on 5th October 2012) to parent National Australia Bank (NAB) and by cuts in fixed costs. The bank made 1,400 employees redundant over the year, and sought other cost reductions. This has resulted in a first half profit for 2013/2014 of £72mn.

Clydesdale is not alone in wondering what to do with its high street branches. In the days when pretty well every banking activity can be done from the home or office, a large branch network is a liability not an asset. This is particularly the case where banks feel the moral pressure of keeping branches open in rural or smaller urban areas for the sake of the community. The flexibility to further reduce fixed costs is therefore somewhat challenging and limited.

On the income side of the bank's balance sheet, whilst the transfer of the commercial loan book has undoubtedly improved capital ratios and liquidity conditions at Clydesdale, it has also reduced forward looking profitability and highlighted what will be playing on the minds of the rating agencies; the lack of a coherent, visionary business model. It is all very well cutting costs and selling assets; this gives a one off benefit, but this high doesn't last forever as without assets where is the income going to come from?

There appears little doubt that parent NAB wants shot of Clydesdale. It has proved to be an investment that simply has not worked. It takes time and energy to run, it detracts from the main stage of Australasia, and it has become like an old hobby that is no longer pursued, like tinkering under the bonnets of old sports cars. NAB would gladly have sold Clydesdale a couple of years back, were it not for the poor economic conditions meaning a complete lack of suitors. It hopes now, with improving conditions to obtain a decent price, enough to appease the shareholders in the home country.

Buying a bank is not however on most investor's agenda at present. With regulatory requirements demanding more stringent rules and strength, making a decent return on capital is going to be a huge challenge for many years to come.

Would be buyers of Clydesdale should have a nagging doubt when they kick the tyres of the bank; not for problems as obvious as two different cars welded together, but more than a sniff of an engine not idling properly. The lack of future revenue is a worrisome component, leaving aside Clydesdale's proclivity for changing customer's contractual borrowing margins (up of course, not down) which surely cannot go on forever, the lack of a corporate loan proposition sits unhappily on the business plan. Add to this the question of the support provided by NAB which is itself a very vexed issue. Clydesdale has benefited from parental capital injections, and from its willingness to lend to it but once Clydesdale has been sold, and the support ceases, the Rating Agencies look set to pounce, and further downgrades would be likely. NAB knows this, would be buyers know it.

So, how to price Clydesdale and what price would NAB accept? Investors must always be wary of hidden costs or flaws, akin to buying a car on the basis that no one has ever smoked in it, only to find subsequently that all of the ashtrays need emptying. The bank has provided £386mn for PPI charges, with £234mn already paid out, so no regulatory worries there. It has also been fined and cleared away the erroneous calculation methodology on some of its retail mortgages. It has also provided £49mn for possible redress costs for mis-sale of interest rate hedging products under the Financial Conduct Authority review. This, we assume also includes potential redress for the very worst form of Tailored Business Loans; those containing embedded structured collars, but it does not include fixed rate Tailored Business Loans.

Could fixed rate Tailored Business Loans be Clydesdale's elephant in the cupboard or the smoking gun in the glove box?

Clydesdale is confident that its fixed rate loan book will not be part of any FCA inspired review, and they are probably right. The FCA has wriggled around and concluded that they should not be. But the problem seems unlikely to go away and at some stage a litigious process will likely question the validity of the costs applied under these loans. The bank applies costs when a borrower either prepays, or the bank itself cancels the loan. These costs it says arise from the cancellation or change to hedging and funding arrangements that it entered with third parties. These costs, which the bank calls 'break costs' have either already been paid by borrowers who have prepaid their loans, or where the bank has called in the loan, or it hangs over the existing borrower making it impossible for them to refinance with a different bank.

Clydesdale seems relaxed about the risk that it won't be able to collect these 'costs' or that it might have to hand back money already received. Its 2008 annual report states that 'the level of prepayment risk is not considered material at present'. In its 2012 annual report the bank states that it 'assesses the risks arising from prepayment behaviour in order to show the potential impact on future cashflows'. The Rating Agencies and potential buyers would be well advised however to ponder upon the potential risk that these costs are not recoverable, and that the costs might not be costs at all, in the event that the bank did not do what it says it did with regards to its hedging and funding activities. If that happens, the bank has an estimated £300-500mn at risk, a figure which NAB (which faces some of the losses itself since it owns a large chunk of the commercial loan book), Standard and Poors and Moodys, and would be suitors are likely to find material indeed.