Weekly Credit Brief

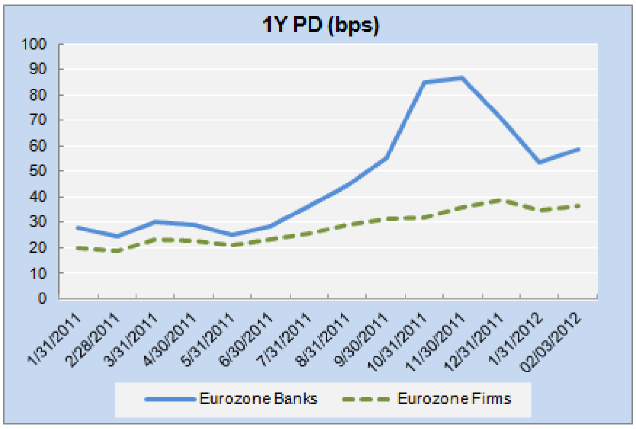
Jan 29 – Feb 4 2012

Story of the Week

Uncertainty hovers over the eurozone despite ECB liquidity scheme, recent EU summit

Liquidity strains have persisted in the eurozone in the past month, despite the €489bn 3-year long term refinancing operation (3-year LTRO) by the European Central Bank (ECB) on December 23. The RMI CRI 1-year aggregate probability of default (PD) for eurozone banks was at 58.7bps on February 3. This is well below highs seen in late 2011, but is still significantly elevated compared to levels below 30bps in the first half of 2011, suggesting that eurozone banks are likely to continue to face a challenging credit outlook. As liquidity pressures continue in the banking system, financing difficulties remain in the eurozone real economy, affecting the credit outlook of eurozone firms. The 1-year aggregate PD for eurozone firms has remained above 30bps for the last few months.

Instead of lending the proceeds of the December's 3-year LTRO to other banks or to the real economy, some banks are parking their funds with the ECB overnight deposit facility, which has continued to increase since December, reaching €488bn on February 2.. Storing 3-year LTRO funds at the ECB is a loss making move for eurozone banks, as the ECB charges 1% on its 3-year loans but only pays 0.25% on overnight deposits, and is a sign that the foremost concern of these banks is safety. Banks may be holding onto 3-year LTRO funds to meet repayment commitments of €230bn in Q1.



Other uses for the LTRO funds involve eurozone banks using the funds to buy higher-yielding bonds issued by peripheral eurozone governments, profiting from the difference in yields. These carry trades further expose the balance sheets of eurozone banks to the risk of the European sovereign debt crisis escalating, leading to capital losses on these government bonds. The president of the ECB, Mario Draghi, stated in January that most banks who borrowed money during December's 3-year LTRO are not the same banks that are depositing funds at the ECB, suggesting a large transfer of sovereign risk exposures in such trades. Increases in ECB deposits and carry trades, and looming bank refinancing needs, suggest that a large increase in the supply of credit to eurozone households and businesses may be unlikely.

In the upcoming 3-year LTRO on February 29, eurozone banks are expected to request double the amount accessed in Decembers 3-year LTRO. While the low cost of 3-year LTRO funds and a widened range of acceptable collateral are contributing factors to increased demand, the expected increase is evidence of continuing bank liquidity strains and negative sentiment in interbank markets.

Meanwhile, uncertainty continued to linger over European leaders' efforts to restore market confidence in the eurozone. Optimism increased in January, as 3-year LTRO funds helped ease the yields on some troubled European countries' government bonds. In addition, 25* out of 27 EU states agreed on January 30 to a fiscal compact advocated by Germany. Under the deal, fiscal budget discipline will be enforced though quasi-automatic sanctions on countries breaching EU budget limits.

However, optimism was dampened as negotiations continued over the restructuring of Greek bonds. Differences between the Greek government and Greece's bondholders remained unresolved last week. Negotiations on bailout details, in particular spending reductions, between the government and the EU, ECB ad the IMF were also not completed last week. If agreements are not reached in the coming weeks, the Greek government will not receive the next tranche of bailout funds, which would lead to a disorderly default by the Greek government when €14.5bn in coupon payments come due on March 20.

*The governments of the Czech Republic and the United Kingdom did not sign the fiscal compact.

Read More:

Banks set to double crisis loans from ECB (FT)
Banks Face Bind Over Cash Pile (WSJ)
European Banks' Dollar Funding Costs Decline to Six-Month Low (Bloomberg)
Europe signs up to German-led fiscal pact (Reuters)
Greece on "knife edge" in last hours to agree bailout (Reuters)

Date	Economy	Title	Summary

Jan 31, 2012	UK	Consumers Repay Debt, Money Supply Shrinks	The UK economy contracted by 0.2% in Q4, with figures released by the Bank of England (BoE) increasing concern that the UK could fall back into recession. Households made a record net repayment of £377mn in personal loans and credit card bills during December. It was the first month since January 2011 that total repayments exceeded new borrowings. Mortgage lending remained below historical levels, despite an increase in December. The BoE is expected to support the economy through a further expansion of its Asset Purchase Facility (APF), after it concluded last October that inflation might be below the target rate of 2% by the end of 2012. Expectations have also been fuelled by a £28.8bn contraction in the UK money supply. An expansion of the APF could increase the supply of credit available to UK firms, which contracted £5.5bn in December. **Read more:** U.K. Consumers Repay Debt, Money Supply Shrinks (WSJ)
Jan 29, 2012	South Korea	Four state banks raise foreign reserves	Four South Korean financial institutions owned by the South Korean government are increasing their buffers against a potential global credit crunch by US$8bn in foreign currency liquidity. This will be secondary to last years $27bn buffer accumulated between 18 South Korean banks. Recent monthly stress tests have shown that Korean banks can sustain a worst-case scenario for 3 months with the additional buffer in place, which is comprised of committed credit lines, currency swap lines and call loans. Despite this, the short term nature of the instruments has raised concerns that this may not be enough to protect Korean banks from ongoing external shocks. The South Korean government has made a number of legal changes since 2008 to address weaknesses in the financial sector identified in a series of reports by the IMF. The changes were aimed at lowering bank dependence on short-term foreign currency borrowing, and also reduced the allowable loan to deposit ratio at commercial banks to 100%. Korean foreign reserves reached $311bn in January, the second highest level in the county's history. The government could use these reserves to protect the economy against external crises. The 1-year PD for Korean banks has remained between 85bps and 100bps since September. **Read more:** 4 state banks raise foreign reserves (Korea Times) S. Korea's foreign reserves hit 5-month high in Jan (Yonhap News)
Jan 31, 2012	India	SBI, rivals seek funds from India government	India's biggest state owned banks should receive additional capital from the Indian government in coming months. Rapid loan growth and a deterioration in asset quality means Indian banks must strengthen their balance sheets and improve capital adequacy ratios. The Reserve Bank of India (RBI) believes bad loans at Indian banks could reach 5.8% of total assets, from 2.8% in September. Research by Fitch suggests that state-run banks' profits may fall by 15 to 20 percent in 2012 due to higher loan-loss provisions. SBI will receive a capital infusion of US$1.6bn from the Indian government through a preferential share allotment. The board of directors of both Punjab National Bank and Central Bank of India last week announced they had approved preferential share issues to the government, of $260m and $141m respectively. Other large state owned Indian banks are also seeking capital from the government. Indian banks had earlier planned to source funds

from equity markets but prolonged weakness in the domestic stock market made this option unfavorable.

In addition to injecting funds into the banking system through equity purchases, the RBI's 50bps cut in the CRR (Cash Reserve Ratio) to 5.5% became effective January 28. The RBI undertook open market operations (OMOs) on February 3, buying $1.8bn in government securities. Including last week's purchases, the RBI has infused $15.4bn into the banking sector. An RBI official stated on January 31 that the RBI may use OMOs to increase liquidity in the banking system as needed in future.

Read more:
SBI, rivals seek funds from strapped India government (Reuters)
Liquidity pressure persists despite CRR cut more OMOs on Friday (Business Standard)

Published weekly by Risk Management Institute, NUS | Disclaimer
Contact the editor at weeklycreditbrief@nus.edu.sg