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Weekly Credit Brief

Jun 5 - Jun 11 2012

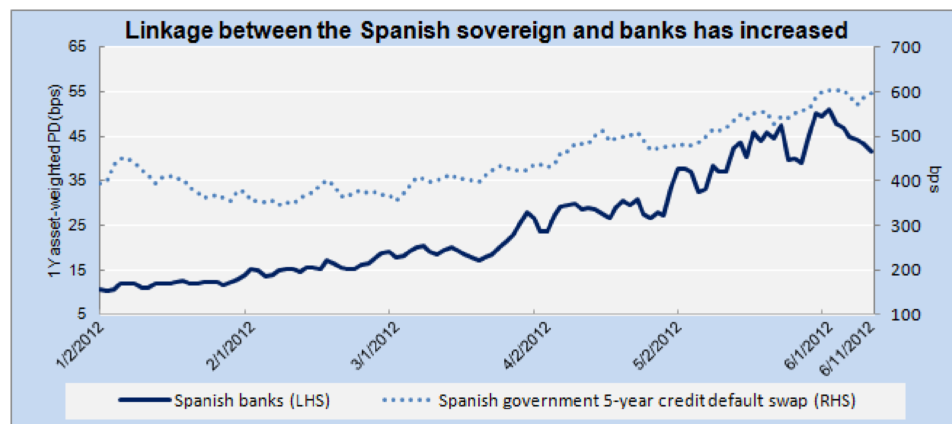
Story of the Week

Spanish government requests bank rescue funds as sovereign linkages increase

The Spanish government requested EUR 100bn from eurozone governments on June 9 to save its struggling banks, abandoning an attempt to recapitalize the country's banking system without external aid. Increasing yields on Spanish government debt and large funding gaps at Spanish banks forced the government's hand, after the results of an IMF assessment on June 8 showed the Spanish banking system needed at least EUR 40bn in new capital. A statement by eurozone finance ministers said the EUR 100bn loan would be enough to cover the capital requirements of Spanish banks with a significant margin of safety, with the former largely aimed at mitigating any adverse effects from the Greek election scheduled for June 17.

The CRI asset-weighted aggregate 1-year probability of default (PD) for the Spanish banking sector fell to 41.6bps on June 11 following the announcement of the rescue funds, after surging to 51.1bps on June 1. Rumours that a bank rescue was imminent last week led to a sharp recovery in the shares of Spanish banks, placing downward pressure on the PD for the Spanish banking sector.

Mechanism: The rescue funds will be channelled through the Spanish bank rescue vehicle FROB, with the risk of an equity injection remaining with the Spanish government. It is still unclear whether the funds will originate from the temporary EFSF, or the soon-to-be operational ESM. Whichever vehicle is used, it is likely that eurozone governments will have seniority over investors holding bonds issued by both the Spanish government and the country's banks.



Increasing linkages: Continued concerns are focused on the relationship between the Spanish sovereign and the banking system, as the rescue funds will significantly increase the debt load of the Spanish government. Moreover, the Spanish Treasury is becoming increasingly dependent on Spanish banks for financing, which have been the largest participants in recent auctions of Spanish government bonds. Spanish banks also purchased large amounts of government debt with funds from the ECB's 3-year LTROs. This linkage is becoming more pronounced, with the correlation between 5-year credit default swaps (CDSs) on Spanish government debt and the asset weighted average PD for the Spanish banking sector increasing in the last three months.

Economy remains a risk: While the interest rate on the rescue funds is believed to be relatively low and the government has avoided any onerous loan conditions, a shrinking economy weighs on the ability of the government and the banking system to eventually repay eurozone members and other creditors. The economy has fallen deeper into recession since the beginning of the year, with unemployment reaching 23.8% in Q1 and retail sales falling 10% year-on-year in April. Poor economic conditions over the past six months led to a surge in bad loan impairments at Spanish banks, in particular at recently rescued Bankia. Increasing loan impairments at Spanish banks were a primary driver of heightened market concerns over the health of the Spanish banking sector in the last month.

Bailout funds may not alleviate concerns: Market concerns remain surrounding the health of the Spanish sovereign, as CDSs on Spanish sovereign debt approached record highs once more on June 11. In addition, yields on 10-year Spanish bonds surged 30bps to almost 6.5% the same day, on concerns the Spanish government will be unable to deal with the large increase in debt. Spanish bank shares fell slightly on June 11 after a brief opening surge, indicating a lack of market confidence in the limited scope of the rescue loans. Furthermore, the lack of a unified eurozone deposit insurance fund could continue to cause large deposit outflows from weaker banking systems.

Sources:

Spain seeks EUR100bn bailout as bank crisis worsens (Bloomberg)

Spanish bondholders may rank behind official loans after bailout (Bloomberg)

In the News

Swedish regulator deals blow to bond haven play
Jun 8. Swedish financial regulator Finansinspektionen imposed a one-year temporary floor on the discount rate domestic insurers and pension funds use to calculate the present value of their long-term liabilities to customers. The move is aimed at protecting insurers and pension funds from soaring liabilities as foreign investors seeking safety from the eurozone crisis bid up the price of Swedish government debt, forcing the market rates funds use in their calculations down. Swedish debt remains attractive to investors due to the country's comparatively low government debt levels and an independent currency. The move may remove the incentive for insurers and pension funds to buy domestic debt, with yields on 10-year Swedish government bonds rising 31bps on June 7. (Finansinspektionen, San Francisco Chronicle)

European Parliament to dismiss plans for European CRA, supervisors under resourced
Jun 7. A vote on the creation of an EU based credit rating agency (CRA) was delayed last week, with members of the European Parliament rejecting the idea. A compromise requiring EU institutions to complete sovereign creditworthiness assessments is also likely to be rejected, with members set to vote on the idea on June 19. In related news, think-tank and consultancy firm Infrangilis published a report last week that compared and contrasted the performance of the largest CRAs in rating sovereign nations. Infrangilis also found that ESMA and several UK government bodies have not dedicated sufficient resources to the supervision of CRAs, with ESMA spending more on postage and telecommunications in a year than on CRA inspections. (EurActiv, Infrangilis)

Geithner seeks details on objections to Dodd-Frank Act
Jun 6. US Treasury Secretary Timothy Geithner last week asked bankers to provide more details on their objections to the Dodd-Frank Act to evaluate the true impact of implementation. The Act was introduced to prevent further taxpayer-funded bailouts of financial institutions and continues to face objections from bankers, in particular the regulatory burden associated with the new rules. US banks claim that a lack of coordination between the US agencies that co-authored the act has created excessive and duplicative requirements. A key part of the Act is aimed at reducing risk and increasing transparency in US derivatives markets. Despite this, Fitch Ratings reported last week that the market is still incredibly concentrated in six large US banks, which continue to account for over 75% of derivative assets and liabilities in the US. (Bloomberg, Fitch Ratings)

Stockton empowers manager to put city into bankruptcy
Jun 6. The Stockton City Council has voted to authorize the town manger to proceed with a Chapter 9 bankruptcy filing if talks with creditors break down. The potential filing would make Stockton the largest US city to ever enter bankruptcy. Stockton's problems are symptomatic of many cities and towns across the US. Deficits soared when liabilities such as pensions and retiree health benefits increased while sales and property-tax revenues plummeted. Stockton's problems were compounded by accounting errors and large borrowings. The California Public Employees' Retirement System (CalPERS) and Wells Fargo are among the largest of 18 creditors involved in the negotiations. A bankruptcy may have severe repercussions for the city, and could lead to repossession of city properties and large budget cuts. (Bloomberg)

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