NUS National University of Singapore | RMI Advancing Risk Management for Singapore and Beyond

Weekly Credit Brief

Nov 27 – Dec 3 2011

Story of the Week:

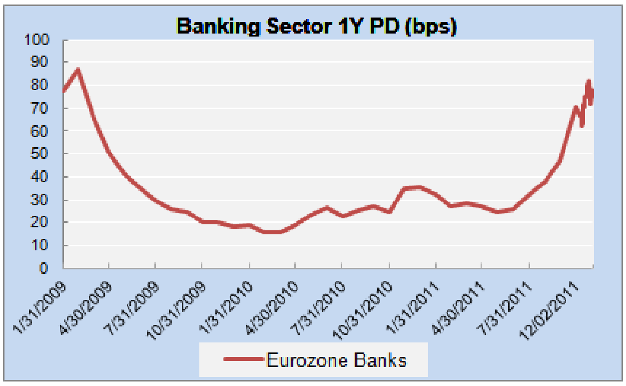
Uncertainty remains despite concerted official liquidity support for European banks

On November 30, the central banks of the US, the UK, Japan, Canada, Switzerland and the ECB announced a joint effort to reduce the cost of emergency US dollar liquidity, and provide contingent funding in the five other currencies. The action will reduce the cost of existing temporary US liquidity swap arrangements by 50bps on all liquidity operations starting from December 5. The central bank swap lines will also be extended to February 1, 2013. The move is expected to reduce the cost eurozone banks face in obtaining emergency US dollar funding from the ECB, via the ECB's US dollar liquidity-providing operations.

European banks have faced difficulties in accessing US dollar funds, as US money market funds cut their exposure to the region. According to Fitch, US prime money market funds reduced their exposure to European banks by 9% during October on a dollar basis. The 3-month euro/USD basis swap spread, which represents the cost of swapping euro payments for dollars, had widened to negative 162.5bps before the announcement, the biggest gap since October 2008. The market reacted positively to the joint central bank move; the basis swap spread contracted to negative 126.3bps on December 2.

Eurozone banks remained concerned about lending euros to each other last week, and increasingly used the ECB's overnight deposit facilities; banks had deposited €314bn overnight at the ECB as of December 1, the highest amount since June 2010. Reflecting the strain in euro interbank lending markets, the Euribor-OIS spread reached 100.6bps on December 1, the highest level since March 2009.

Meanwhile, EU finance ministers announced on November 30 that EU governments would offer guarantees on bonds issued by their domestic banks, in an effort to revive the European wholesale lending market. This could alleviate the long-standing difficulty banks have faced in raising unsecured, long-term funding. Concerns remain however, as a rejected plan to provide syndicated guarantees, backed jointly by EU governments, would have been more effective. Some market participants also question the effectiveness of guarantees from sovereigns whose own creditworthiness are in question.



European banks face a widening funding gap; banks issued $744bn in debt this year, including covered bonds, but faced debt redemptions of $888bn during the same period, creating a funding gap of $144bn in 2011, according to Dealogic. European banks also face debt redemptions of over $1tr in 2012, while euro-area governments must repay more than $1.5tr of debt in 2012, Bloomberg data shows. Banks will effectively be competing with sovereigns for large amounts of funding next year, which may create an even larger funding squeeze in 2012.

Uncertainty in credit conditions is likely to continue in Europe. According to RMI's default forecast model, the 1-year probability of default (PD) for eurozone banks fell a substantial 7.2bps to 74.7bps on December 2, from a high of 81.8bps on November 25, the highest PD for this group since March 2009. However, the PD remains at a high level relative to values earlier this year.

Read more:

Coordinated central bank action to address pressures in global money markets (ECB)
Central Banks Cut Cost of Borrowing Dollars (Bloomberg)
Fitch: US Money Market Funds Cut Exposure To Europe's Banks (WSJ)
Dollar Funding Costs Cheapest in Two Weeks After Swap Rate Cut (Bloomberg)
Central Banks Pushed to Act as Funding Squeeze on Banks Worsens (Bloomberg)
Finance Ministers Agree to EU Debt Guarantees (WSJ)
Europe's banks feel funding freeze (FT)
Banks Vie With Nations to Sate $2 Trillion Need (Bloomberg)

Date	Country	Title	Summary
Nov 29, 2011	UK	Lenders to SMEs get government boost	A UK government's plan to boost lending to Small and Medium Sized Enterprises (SMEs) was announced last week by Chancellor of the Exchequer George Osborne. The policy would provide loan guarantees that increase bank lending to SMEs and attempt to stimulate the economy. The proposed guarantee scheme should decrease bank borrowing costs when lending to SMEs, allowing

			SMEs to benefit through cheaper loans. The UK government plans to underwrite £20bn of bank funding in efforts to reduce the rate of interest being charged to small companies by one percentage point. In related news, Santander UK will extend its commitment to small businesses through a new £200mn ($314mn) fund, aimed at providing finance to companies that are struggling to obtain unsecured credit. Lloyds and RBS have also increased their commitment to SME lending in previous weeks. **Read more:** Lenders to SMEs get government boost (FT) Santander UK launches £200m SME fund (FT)
Nov 30, 2011	Europe	Europe Bank Distress May Offer Insurers Buying Opportunity	The forthcoming Basel III reform package will impose tough liquidity and capital constraints on banks, and as a result, banks in France, the UK, Ireland, Germany and Spain plan to shrink their balance sheets by about €775bn ($1.03 trillion) over two years. In efforts to do so, Barclays sold a $740mn portfolio and Société Générale has launched the sale of property loans worth more than $799m and suspended writing new loans on European and UK property. BNP Paribas has plans to sell a private equity portfolio of more than $700mn. Banks are looking toward insurers along with mutual and pension funds to sell these assets. **Read more:** Europe Bank Distress May Offer Insurers Buying Opportunity(Bloomberg) SocGen to sell €600m worth of property loans (FT) BNP considers private equity portfolio sale (FT)
Dec 01, 2011	China	China Cuts Reserve-Requirement Ratio	Affected by the negativity from Europe's debt crisis and the fragile recovery in the US, China has reduced its bank reserve requirements in an attempt to stimulate its economy. This is the first cut in the reserve requirement ratio in almost three years. The People's Bank of China reduced the reserve requirement ratio by 0.5%, taking the level to 21% for major banks. This monetary policy would free up around 390bn Yuan ($61 billion) in funds. Despite the official action to increase liquidity in the Chinese economy, Chinese firms are still facing challenges due to the crisis facing developed economies. According to RMI's default forecast model, the 1-year aggregate PD for China's public firms remained high at 155bps on December 2, compared to the low of 120bps in April. **Read more:** China Cuts Reserve-Requirement Ratio (WSJ) Chinese reserve ratio cut boosts Asian banks (FT)
Dec 02, 2011	US	American Airlines and AMR filed for bankruptcy as AMR backed municipal bonds face default.	American Airlines filed for Chapter 11 bankruptcy protection on November 29 amid challenging business conditions. In the suit, AMR Corp, the parent of American Airlines, also filed for bankruptcy. The company had assets of about $25bn and liabilities of about $30bn. AMR sold tax-exempt securities called special-facilities bonds through airports and municipal authorities. Following the bankruptcies, the value of the municipal securities dropped by as much as 68%. According to RMI's default forecast model, the 1-year aggregate probability of default (PD) for AMR Corp. rose to 400bps on November 28, the day before the actual day of default, from the low of 49.2bps on May 31.

			Read More: AMR Bonds Signal Plan to Ditch Older Jets in Bankruptcy: Corporate Finance(Bloomberg) American Airlines files for bankruptcy (Reuters) AMR files for bankruptcy protection (FT) AMR-Backed Municipal Airport Bonds Decline on Bankruptcy Filing (Business Week)
Dec 5, 2011	India	Indian groups risk default on dollar debt	Some Indian companies will face difficulties with their USD-denominated debt recently becoming more expensive due to the rupee's 14% drop against the USD since August. Between 2005 and 2008, many Indian companies had raised cheap debt through foreign currency convertible bonds, taking advantage of the favorable economic conditions at the time. However, given that the Bombay SENSEX index has fallen 22% this year, bondholders now prefer bond repayment to conversion, placing greater pressure on Indian companies. The Reserve Bank of India (RBI) has made only limited moves to stem the rupee's decline, after being criticized for failing to match central bank currency actions in other emerging economies. The rupee may stay weak, placing the burden on Indian companies which face high repayment costs on their debt. According to RMI's default forecast model, the 1-year PD for Indian firms has risen to 40.6bps on December 2, from 26.1bps on June 30. **Read more:** Indian groups risk default on dollar debt (FT) Slowing domestic demand hits rupee (FT) Pace of rupee depreciation may slow down (The Hindu Business Line)