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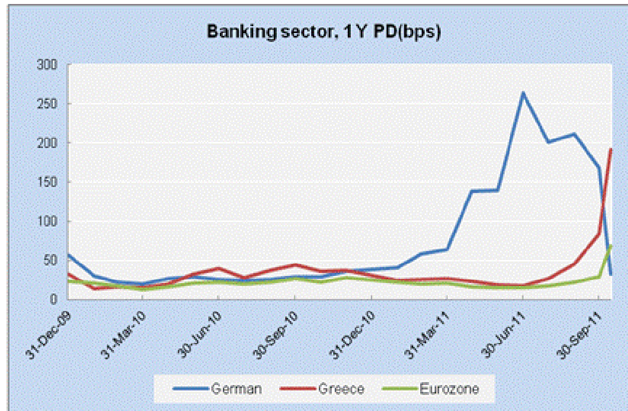
Weekly Credit Brief

Oct 9 – Oct 15 2011

Story of the Week:

Eurozone debt crisis intensifies amid deepening bank woes

French and German leaders announced Sunday they will agree on a plan to recapitalize the regions banks and strengthen the European Financial Stability Facility (EFSF) by the end of October. In addition, EU leaders are expected to set minimum tier1 capital levels under certain stress scenarios, and higher levels in no-stress scenarios, forcing banks to raise new capital. Policymakers are also discussing an insurance plan that would leverage the current €440bn EFSF resources to provide sovereign debt guarantees up to €2,900bn.



However, uncertainty remains over EU efforts to resolve the Eurozone debt crisis, and protect the region's banking system. Even with a beefed up EFSF, the resources may not be sufficient in containing the debt crisis, given that the cost of recapitalizing Eurozone banks could reach €200bn and the large Italian bond market. In addition, there are signs the debt crisis has spread outside indebted peripheral countries. The yield on 10-year Belgian bond yields soared to 4.4% on October 14, close to the yield of 5.2% registered on the same day for Spanish bonds. A dissenting German banking sector is another challenge, as German banks are opposed to EU plans that involve a forced recapitalization of European banks. German bankers wish to avoid state capital, or forced equity issuances, due to the difficulty of raising capital in the present climate. Their resistance to a compulsory recapitalization is also based on confidence in their existing sound capital positions. According to RMI's default forecast model, the 1-year aggregate probability of default (PD) for German Banks was 33.1bps on October 14, compared to 83.5bps on September 30. The 1-year aggregate PD for Eurozone banks has soared to 68.9bps from 29.1bps over the same period.

Meanwhile, the divestment of the Franco-Belgian bank Dexia was formally agreed on October 10. Belgium would take over the banks domestic operations, French banks led by CDC would take over Dexia's French municipal loan business, while other Dexia operations would be up for sale. A shell company will retain a leveraged portfolio of bonds, with the French, Belgian and Luxembourg governments agreeing to underwrite up to €90bn of the portfolio's financing needs. The 1-year PD for Dexia jumped to 279.7bps on October 14, more than three times higher than the PD of 77.3bps recorded on September 30.

The intensifying debt crisis is also seeing impacts spreading to banks from non-peripheral economies. A series of write downs related to peripheral Eurozone economies has caused the Austrian bank Erste to issue warnings of heavy losses for the current year. Compounding Erste's problems is the controversial implementation of a Hungarian law that allows mortgagors to pay back foreign currency loans at favorable exchange rates. The 1-year aggregate PD for Erste has risen nearly two fold to 67.9bps on October 14 from the PD of 39.7bps recorded on September 30.

Some European banks are suffering problems not directly caused by the debt crisis, as two smaller European lenders were broken up this week. Danish-based Max Bank was broken up following an investigation by Danish regulators which revealed that the bank no longer met solvency requirements, due to losses from risky loans in the building and real estate sectors. The Greek bank Proton is being divided into two banks, with Proton officials blaming a bad loan portfolio and funding problems. The 1-year aggregate PD for Greek banks increased more than 100bps from September 30 to 191.2bps on October 14.

Read More:

Insurance plan to boost rescue fund's reach (FT)
German banks attack recapitalization plan (FT)
Banks Brace for Capital Calls After Dexia Rescue (CNBC)
Erste faces loss after heavy writedowns (FT)
Max Bank Tests Banish Consolidation Bill as Bail-in Shelved(Bloomberg)
Greece Effectively Nationalizes Lender Proton Bank (CNBC)

Date	Country	Title	Summary
Oct 9, 2011	US	Fannie and Freddie debt fuels anxiety	Asian and Middle Eastern central banks and sovereign wealth funds, including the Kuwait Investment Authority and National Pension Service of Korea, are increasingly concerned about the safety of their investments in debt issued by Fannie Mae and Freddie Mac. These Government Sponsored Enterprises (GSE), which own or guarantee most US mortgages, were nationalized just before Lehman Brothers collapsed in 2008.

			Major investors have reduced or sold off their holdings of debt issued by the US Treasury-backed housing agencies since the global financial crisis. Political wrangling over the increase in the US Debt ceiling, the recent ratings downgrade of US sovereign debt, and GSE dependence on the Fed has increased investor anxiety. According to Bloomberg, foreign central bank holdings of GSE debt have fallen 26.4 per cent to $724bn today since an investment peak in mid 2008. A study by The Council on Foreign Relations think-tank showed that purchases of Fannie and Freddie debt by BRIC central banks has also declined since 2008. The Federal Housing Finance Agency, the US agency that regulates Fannie and Freddie, has attempted to reassure investors; in the case of any defaults they would have support from the US Treasury. Despite market fears, GSE debt is still trading at a narrow spread over treasury rates, as Fed quantitative easing has reduced yields. **Read More:** Fannie and Freddie debt fuels anxiety (FT)
Oct 13, 2011	US	Reforms aim to improve transparency of rating	US policymakers are drafting new regulations aimed at improving the transparency and accountability of credit rating agencies. The proposed regulations require ratings agencies to disclose the assumptions underlying their ratings methodology, and whether companies or investors have paid for assessments. Ratings agencies are also required to ensure their analysts are not compromised by promises of future employment, have no involvement in the sale of ratings, and receive proper training and testing. In addition, the firms must disclose information provided by banks and mortgage lenders regarding the quality of underlying assets when rating mortgage-backed securities, and an assets' performance relative to comparable transactions. They also need to reveal the historical performance of their ratings. If they use a due diligence report completed by a third party during an evaluation, the report's conclusions must be made publicly available. However, the legislative reform does not US consumer groups biggest concern with ratings agencies: the conflict of interest arising from ratings firms being paid by the companies they rate. The three largest ratings firms all follow this model, and lawmakers believe the firms exaggerated their MBS ratings during the financial crisis in order to win business. **Read more:** Reforms aim to improve transparency of rating (FT)
Oct 13, 2011	Europe, Ireland	European bank debt market sees thaw	The European capital market exhibited signs of improvement this week, as several banks successfully issued senior unsecured debt with long-dated maturities. The Sweden-based Handelsbanken raised €1.25bn of 10-year bonds, and Standard Chartered sold a similar amount of 5-year debts. The securities are priced at a spread of 170bps and 190bps over benchmark mid-swap rate respectively. Earlier this week, the Dutch-based Rabobank sold €1.5bn of 7-year notes at 25bps over the 3-month Euribor rate. Traditionally, senior unsecured debt is a primary source of bank funding, but the market had dried up following the Eurozone debt crisis. Deutsche Bank and ABN Amro ended the drought in September with short-term issuances, but offerings this week are the first longer-dated bonds. Notably, the issuing banks have low exposure to indebted Southern European states; Handelsbanken is a large Nordic lender, while most of Standard Chartered's business is outside of Europe. Separately, the Bank of Ireland sold €1.1bn of covered bonds backed by its UK residential mortgage book. This is a positive sign for Irish banks, which have had difficulty obtaining non-government guaranteed funding since the outbreak of the Eurozone debt crisis. According to RMI's default forecast model, the 1-year PD for Handelsbanken decreased to 17bps on Oct. 14 from 17.8bps on Sep. 31. Standard Chartered's 1-year PD decreased to 5bps

			from 6.3bps during the same period. **Read More:** European bank debt market sees thaw (FT) Rabobank bonds sale tests appetite for debt (FT) Bank of Ireland bond sale raises €1.1bn (FT)
Oct 10, 2011	US	PrimeX indices suggest mortgage concerns are spreading	Markit's PrimeX family of indices, which allow investors to go long or short in the high-quality US housing market, are linked to the performance of securities backed by high-quality US mortgages. PrimeX indices have a "par" value of 100; values below 100 imply added risk. In the early stages of the financial crisis, PrimeX indices briefly dipped below par, managing to stay above par in the following years. In the first week of October, many of the indices began dipping below par. According to Fitch, which completed a review of the prime mortgage market, there are ongoing problems in US mortgage markets which include more borrowers falling behind in their payments, volatility in investor sentiment, and the bearishness of credit markets relative to equity markets. In addition to the problems listed by Fitch, a report published this week by RealtyTrac stated that an upswing in default notices suggests foreclosures could start to rise again this quarter. Notices were down 27% from the same time a year ago. **Read More:** PrimeX indices suggest mortgage concerns are spreading (FT) Mortgage default notices spike in Q3: RealtyTrac (Reuters)
Oct 9, 2011	Global	Banks to be forced to boost liquid assets, capital	Despite a continuous lobbying effort from US and French banks, the Basel Committee on Banking Supervisions has decided to start the first worldwide effort to force banks to hold more liquid assets and reduce their dependence on short term financing. Basel III regulations will also force banks to hold additional high quality capital to cope with unexpected losses. Uniform implementation of Basel III reforms has become the group's top priority. The European Banking Authority has moved ahead to approve in principle a 9% core tier one capital ratio. According to estimates by Morgan Stanley, European banks would have to raise €275bn in aggregate to comply with the new rule. Meanwhile, continued stress in the inter-bank market has sent overnight deposits at the ECB to €269bn, the highest since June last year. **Read More:** Banks to be forced to boost liquid assets (FT) Europe's banks face 9% capital rule (FT)
Oct 12, 2011	US	Most hedge funds to escape tighter oversight	US regulators voted on Tuesday to only assess the risk of non-bank financial groups with total assets greater than $50bn. Companies with collective assets over $50bn, which also breech leverage and liquidity metrics, will be deemed "systemically important." Qualifying institutions would be subjected to more stringent regulation and higher capital requirements. The vote has allowed most hedge funds and private equity firms to escape closer regulation, since they typically hold less than $50bn in assets. However, many insurance institutions might be shortlisted, as they typically exceed the threshold. Officials from the US Treasury and the Federal Reserve explained the criteria was a rough guide, and a number of companies that qualify may be exempted from tighter oversight. Officials also stated they had a short list of institutions below the threshold which may still be subject to greater regulation. **Read More**: Most hedge funds to escape tighter oversight (FT)
Oct 14, 2011	Australia	Covered bond legislation does not ease market concerns	A rise in the cost of insuring Australian bank bonds through CDS markets has heightened concerns that Australian banks will face increased funding costs if European commercial paper markets were to freeze up.

			Friday's passage of legislation allowing the issuance of covered bonds will help diversify the funding base of Australian banks. This will reduce reliance on wholesale funding markets, and allow for significantly cheaper lending costs. A government cap on covered bond issuance of 8% of total assets is not a concern, with the industry expected to take advantage of lower lending premiums to issue over $100bn in 2012. The cash-flow of Australian banks has remained steady in the last few months, as credit growth has decreased, and customers have increased deposit holdings, reducing aggregate annual funding needs by over $40bn. Overall, exposures to troubled Southern European sovereign debt makes up less than 1 % of Australian bank balance sheets. The real concern is the slowdown in global markets, especially commodities markets, which would hurt Australian borrowers. According to RMI's default forecast model, the 1-year aggregate PD for Australian banks has risen to 75.5bps on October 14, from 22.6bps on September 30. **Read More:** Aussie Bank Fears Lurk Underground (WSJ) New funding for banks a safe harbor in the storm (The Australian)
Oct 11, 2011	Global	Clearing US OTC swaps may be required by April, Europe lags behind	US market participants may need to start centralized clearing by April if clearing houses complete relevant regulatory submissions before the end of the year. OTC derivatives are widely regarded as worsening the Financial Crisis, and the clearing of "standardized" OTC derivatives by centralized exchanges is part of regulatory efforts to monitor and reduce systemic risk in the financial system. The Basel-based Financial Stability Board is concerned that EU regulators are not pressing ahead with reforms in this area. The FSB is afraid that smaller countries are delaying their own implementation of rules regarding OTC contracts in order to see what rules emerge in the US and Europe; the FSB is pushing for a simultaneous implementation globally. Regulators are also worried that the reach of Dodd-Frank rules beyond US markets could cause further fragmentation of rules in this area. These reforms are aimed at reducing counterparty credit risk, by increasing transparency in financial markets. We believe these regulatory requirements may place downwards pressure on aggregate probability of defaults produced by RMI's default forecast model. **Read More:** US may start OTC derivatives clearing by April (FT) FSB calls for action on OTC derivative reform (FT)
Oct 13, 2011	Global	Fitch downgrades UK Banks, puts other banks on review	Fitch has downgraded the ratings of UBS, Royal Bank of Scotland and Lloyds Banking Group, and placed seven other U.S. and European banks on a negative credit watch. Challenges in the economy and financial markets, the impact of new regulations, and expectations that UK banks will receive less support from the UK Government were cited as the reasons for the downgrade and outlook on UK banks. US banks were placed on a negative credit watch due to exposures to the Eurozone debt crisis, and concerns about the business model of non-deposit taking investment banks. Fitch lowered RBS and Lloyds by two notches from AA- to A and UBS's long-term issuer default rating to A from A+. Fitch placed Barclays Bank,bnP Paribas, Credit Suisse Group, Deutsche Bank, Societe Generale, Bank of America, Morgan Stanley and Goldman Sachs Group on a negative credit watch. **Read More:** Fitch downgrades UBS, puts other banks on review (Reuters) Banks drive London losses after Fitch cuts ratings (FT)
Oct 12, 2011	China	China Unveils Steps To Ease Credit Crunch For Small Firms	The Chinese government is helping small businesses facing high taxes and limited financing sources by allowing them to issue more bonds, raising relevant tax thresholds, and making multiple sources of financing available. In addition, the government has reduced the reserve requirement ratio of small

			banks to 19.5%, compared to a ratio of 21.5% for larger banks, in order to increase lending. This measure is aimed at addressing the underground lending market, which has seen annual interest rates as high as 100% for small cash-strapped firms that are unlikely to get loans from big banks. However, these steps should be seen as providing financing support for small business, rather than a sign of an easing in banking regulation. **Read More:** China Unveils Steps To Ease Credit Crunch For Small Firms (Reuters)

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