Weekly Credit Brief

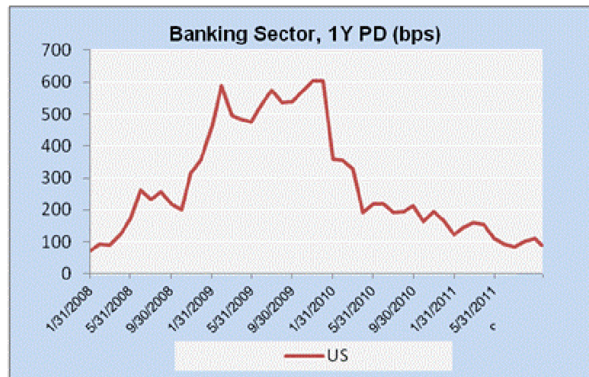
Oct 16 – Oct 22 2011

Story of the Week

US banks are facing an array of problems

The largest US Banks delivered generally mixed earnings reports last week, pointing to some challenges still confronting the banks. While most of these banks reported profits, earnings reports illustrated that bank profits were largely dependent on unsustainable income sources. Profits reported by Bank of America, Citigroup and Morgan Stanley largely, for example, consisted of accounting gains on company issued debt. US banks are also facing a number of potential risks in their lending activities. Additionally, large US banks all reported earnings drops from investment banking and capital market activities, partly stemming from problems in Western Europe. As a result of these factors, US banks are still facing a negative credit outlook. According to RMI's default forecast model, the 1-year aggregate probability of default (PD) for US banks stood at 91bps on October 21, an 18bps decrease from September 31. However, the PD is still above 84.3bps recorded in July.

A majority of loan growth reported by US banks in the third quarter has come from the strongest borrowers taking advantage of low interest rates. In addition, European lenders ceded market share to American Banks, indicating loan growth in the third quarter may be unsustainable. Deposit growth has outpaced loan growth, resulting in reduced net interest margin from traditional banking activities.



Weak housing market activity in the third quarter highlighted continued vulnerability in bank mortgage activities. US lenders also reported that existing borrowers are falling behind on repayments, creating concern that record low interest rates and government loan modification programs will not prevent an increase in delinquencies. Residential mortgages remain the most significant risk facing US Banks, as delinquencies spread from subprime to prime mortgages. An increase in credit card defaults is also expected in the next few months.

Lawsuits filed by the Securities and Exchange Commission (SEC) against American banks over financial malpractice in the lead up to the financial crisis pose an ongoing risk to bank profitability. Citigroup completed a $285mn settlement with the SEC last week, over charges the bank bet against products sold to investors. The SEC aims to resolve a number of similar cases with Wall Street institutions in the coming months.

Student debt is another problematic area for US banks, as an increase in debt loads and high unemployment has caused a growth in delinquencies since 2009. The 1-year PD for US student loan originator Sallie Mae remained above 150bps on October 21, well above pre-financial crisis levels, highlighting ongoing credit risk in the student loan sector.

Read More:

Big US banks hurt by struggling consumers (FT)
Banks Start to Make More Loans (CNBC)
http://online.wsj.com/article/BT-CO-20111017-711753.html (WSJ)
Existing Home Sales Fell 3 Percent in September (CNBC)
Citi pays $285m to settle SEC case (FT)
US student debt impact likened to subprime crisis (FT)
Student Loan Debt Hits Record Levels (CNBC)
Morgan Stanley produces profit of $2.2bn (FT)
Citigroup earnings rise 74 percent, to $3.8 bln (Houston Chronicle)
Goldman Sachs loses $428 million in third quarter (MSN news)
Bank of America struggles, but asset sales help (Reuters)

Date	Country	Title	Summary
Oct 16, 2011	UK	Banks and insurers defend 'liquidity swaps'	Reports emerged this week that the Financial Services Authority has blocked a number of liquidity swaps between UK banks and insurers this month. A liquidity swap helps improve a banks funding base, as banks can borrow from a large pool of high quality government bonds owned by insurers. Insurers receive fee income from lending the securities, and the bank posts a large pool of illiquid assets as collateral for the deal. The FSA fears such trades could further aggravate financial stability in a liquidity crisis, as they increase the interconnections between banks and insurers. These deals

			give insurers concentrated exposure to loans made by banks, if a bank goes bad there is a high probability the bank's loan portfolio will also be impaired. If the creditworthiness of a bank deteriorates, an insurer can force the bank to post additional collateral, or unwind the swap, which would further compound bank balance sheet problems. Such a scenario is reminiscent of insurance deals between AIG and Goldman Sachs leading up to the government bailout of AIG in 2008, except in the opposite direction. **Read More:** Banks and insurers defend 'liquidity swaps' (FT) Welcome for liquidity swap blocking (FT) Liquidity cops (FT)
Oct 19, 2011	Australia	Australian banks: evading the European Crisis, First covered bond issuance	According to the Assistant Governor of the Reserve Bank of Australia, banks in Australia are evading the European debt crisis, and in some cases benefitting from it. Given that many Australian banks have overseas operations, and have historically sourced a majority of funding from European markets, there was concern over exposures to the crisis. Australian banks have reduced their exposure to the debt crisis compared to last year: deposit growth has outstripped credit growth for more than two years; therefore banks do not face the same funding problems as their European counterparts. In addition, US money market funds have been moving funds away from European markets; Australian banks have been beneficiaries of reallocated funds. The AA-rated National Australia Bank (NAB) is expected to become the first major Australian bank to issue a covered bond, after legislative changes last week. NAB is planning issuances worth up to $1 billion. Other Australian banks are expected to make issuances in the near future, in order to diversify their funding bases and reduce exposure to costly wholesale funding markets. **Read More:** Banks side-stepping much of Europe debt crisis: RBA (The Australian) RBA: Australia Banks Find Funding Easier Than Euro Rivals (CNBC) Banks race to tap bond boom, with NAB first off the mark(The Australian)
Oct 16, 2011	United Kingdom	Pensions worry QE2 will raise liabilities	For much of the past decade, pension funds and insurance companies have been forced to hold large amounts of government debt. The Bank of England's (BoE) QE2 program, which started last week, involves the BoE buying £75bn ($118bn) of UK government gilts, and pension funds are being encouraged to sell government debt holdings to the BoE. Crucially, the BoE purchases are not being matched with new issuances, leaving pension funds and insurers as net sellers. The key issue facing pension funds is a lack of long-term government debt to hedge multi-decade liabilities. In addition, by raising demand, QE2 is likely to further depress gilt yields, which are already at historic lows, with the BoE estimating that QE1 lowered gilt yields by 100bps. This reduces the rate that can be used to discount future pension payments, increasing the current liabilities of pension funds. The BoE has stated that pension funds will benefit from price increases on non-government debt, but concerns remain, as such benefits are market dependent. **Read More:** Pensions worry QE2 will raise liabilities (FT)
Oct 21, 2011	China	China to let local governments issue bonds	China's Ministry of Finance has announced a pilot program to allow local authorities to issue bonds, to help them repay over $1 trillion in outstanding loans. Beijing has prevented local governments from issuing debt since 1994, issuing bonds on their behalf in limited quantities. Increasing usage of special purpose vehicles designed to skirt this restriction had created concern over the stability of local government finances. The pilot program aims to offer financing alternatives, and is limited to the Shanghai, Guangdong, Zhejiang and Shenzhen authorities initially. According to Standard & Poor's, the growth rate in local government debt doubled in 2009, while fiscal revenue only

			grew 20%. Chinese local governments increasingly depend on land sales as a source of revenue, accounting for 40% of income last year. A cooling in property markets in recent months has decreased revenues. With 25% of local government debt due by year end, Chinese banks face an increase in problem loans, as they have large holdings of local government debt. The pilot program is aimed at moving local government debt off bank balance sheets, to reduce the risk of a banking crisis. **Read More:** China To Let Local Governments Issue Bonds (WSJ) China municipalities to issue bonds (FT)
Oct 19, 2011	EU	EU bank recap could be under 100 billion euros	A recent stress test by the European Banking Authority (EBA) suggested that banks needed to raise total capital between €70 billion to €90 billion, in order to meet the 9% threshold for the core tier one capital ratios. This result was far lower than a recent estimate of €200 billion by the International Monetary Fund (IMF), and market estimates of €275 billion. The model used by the EBA tests offset healthy sovereign debt, such as British gilts or German bilds, against peripheral sovereign debt, leading to a lower result. However, the model is still subject to debate over key assumptions, and did not consider the risk of severe economic downturn, which was included in EBA stress tests last year. **Read more:** EU Banks Recap Could Be Under 100 Billion Euros (CNBC)
Oct 18, 2011	China	China's bond markets flash a warning of what is to come	Two key measures of Chinese bond markets are creating concern about the wider economy, according to the IMF. The first indicator is the yield curve for bonds issued by the three Chinese policy banks - China Development Bank, Export Import Bank of China and Agricultural Development Bank of China. The slope of the yield curve, the difference between the 10-year and 1-year bond yields, shrank to 0.6% on Oct. 14, from 1.1% at the end of March. Although this reduction is partly caused by sell-offs to meet demand for cash, it reflects lower growth and inflation forecasts. The second measure is the credit spread between AAA-rated corporate bonds and government debts. The difference in yields of AAA companies and 10-year treasury bonds widened to 2.3%, from 1.2% at the beginning of the year, reflecting increasing concern about potential defaults by Chinese firms. According to RMI's default forecast model, the 1-year aggregate PD for Chinese firms reflects this view, increasing to 148.3 bps on Oct. 21, from 122.1 bps on Apr. 30 **Read more:** China's Bond Markets Flash A Warning of What's to Come (WSJ)
Oct 16, 2011	China	Chinese banks fight for deposits	Statistics recently released by the Chinese central bank showed that China's M2 has been growing at 1% below forecasts. The Chinese government also reported a net outflow of bank deposits for the first half of the month. This came amid depositors' increasing switch away from low-yield traditional deposits, and efforts by Chinese banks to attract customers with alternative products, such as wealth management products and loans structured as short-term investments and kept off balance sheet. The surge in such alternative investment products has worried the China Banking Regulatory Commission(CBRC). Beijing is concerned the increase in such products reveals shortcomings in the banking sector, and has scaled up efforts to contain the business. Regulations that come into effect next year prevent banks from using wealth management products to circumvent the rate ceiling, requires banks to disclose risks to customers in a timely manner, and limits the way wealth management products can be marketed. **Read more:** Chinese banks fight for deposits (FT)
Oct 18, 2011	Italy	S&P downgrades 24 Italian banks, financial firms	After the downgrade of seven Italian banks in September, Standard & Poor's has downgraded 24 Italian banks and financial companies in the past week. The downgrade came after a new round of market tensions built up in Eurozone's periphery. High yields of Italian

			government sovereign bonds would translate into higher borrowing costs for Italian financial institutions. In addition, slow economic growth would continue to undermine their ability to generate revenue. S&P believes that the outlook for Italian financial institutions would continue to be bleak. According to RMI's default forecast model, the 1-year aggregate PD for the Italian financial sector rose to 42bps on October 21, from 30.2bps on January 31. **Read More:** S&P downgrades 24 Italian banks, financial firms (International Business Times)
Oct 18, 2011	Italy	Bond freeze ends for companies on euro periphery	Telecom Italia reopened the corporate bond market in peripheral European countries with a €750 million senior unsecured bond issuance in early October. In the weeks since, other companies from Italy and Spain, including Iberdrola, Enel and Telefonica, have pushed ahead with bond issuances. Most of these issuances were oversubscribed. No corporate bond issuances have been observed in peripheral European countries during August and September, as market volatility was extremely high. These recent successful corporate bond issuances indicate improved market sentiment. Notably, Italian utility company Enel had its four-year bond issuance priced at a yield of 4.625%, lower than yields on equivalent Italian government sovereign bonds. Bankers expect more corporate bond issuances from Italy, Spain, Portugal and Ireland once the macroeconomic and political conditions in these countries stabilize. **Read more:** Bond freeze ends for companies on euro periphery (FT) Enel debt priced as safer bet than Italian sovereigns (FT)

Published weekly by Risk Management Institute, NUS