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Weekly Credit Brief

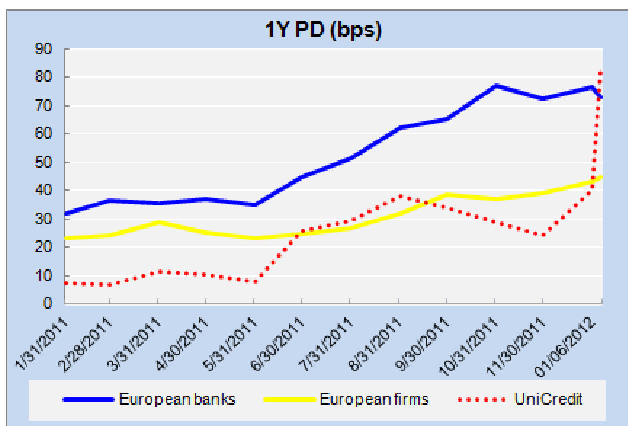
Jan 1 – Jan 7 2012

Story of the Week:

European sovereign debts in focus while bank funding and capital problems continue

Last week was a major test for European sovereign bond markets, and whether the 3-year loans provided by the ECB to the region's banks on December 21 have eased stress in sovereign debt markets. Yields on 6-month Italian debt dropped 20bps from January 2 to January 6, as eurozone banks may have invested the proceeds in short term Italian sovereign debts. However, stress continued to show in the sovereign debt market. Yields on 10-year Italian sovereign debt rose 20bps from January 2 to January 6, while yields on 10-year Spanish debt rose 60bps during the same period, reversing gains since December 21. This week is set to be an even greater test, as European governments are expected to sell over €21bn of debt, with Italy and Spain auctioning bonds of various maturities.

Against ongoing sovereign debt problems, the European market for senior unsecured bank debt, the traditional source of funding for European banks, saw a revival last week, as debt issuances were placed by northern European banks, which are still considered safe by investors. However, after a year of increasing dependence on covered bonds and ECB funds in 2011, access to private market funding may remain difficult, especially for banks in debt-stricken countries such as Italy and Spain. European banks face around €700bn in maturing debt this year, a majority of which must be rolled over in the first quarter.



If the region's banks are unable to refinance these maturing debts, they could face liquidity problems, and may have to shrink their balance sheets, which could increase the chance of a credit crunch and recession across the Europe. In addition, much of the funds borrowed during the ECB's 3-year loan operation may have been placed in the ECB's overnight deposit facility, preventing much of the funds reaching other banks or the real economy. As a result, European firms hold a negative credit outlook. The RMI CRI's 1-year aggregate probability of default (PD) for European firms has risen to 44.9bps on January 6 from a low of 23.2bps last May.

Meanwhile, signs of stress in the interbank lending market continued. The Euribor OIS spread remained elevated at 95.6bps on January 6 while the Libor OIS spread reached 50bps on the same day, a level last seen in May 2009. Banks drew €79.2bn from the ECB's marginal lending facility over the past two weeks, the highest amount since February 2011

According to European regulators' requirements, 31 European banks need to outline their capital raising plans by January 20 to show how they are going to meet the 9% core tier 1 capital ratio requirement set by the EBA, before the June 31 deadline. However, capital raising may prove to be challenging for European banks amid waning investor support. Highlighting this, Unicredit's plan to raise additional capital through a rights issue caused the banks shares to decline 37% last week. The credit outlook for Unicredit has deteriorated, with its 1-year PD soaring to 82.9bps on January 6, from only 7bps in last January.

Compounding European banks' capital raising woes, European banks are facing increased difficulty in accumulating capital through internal methods. Banks' earnings prospects are dampened as investment banking revenues decline, and expected loan losses increase. While EBA estimates place the capital required by European banks at €115bn, some market participants believe the capital needs for European banks could be as high as €400bn. Reflecting their worsening credit outlooks, the 1-year PD for European banks has climbed to 72.7bps on January 6, from 31bps in last January.

Read more:

Refinancing Race to Dominate Third Year of Crisis (Bloomberg)
Italy, Spain embark on tough funding test (Reuters)
ECB lending surge continues (FT)
Europe's banks rush to sell bonds (FT)
Key financial risk measure hovers near 3-yr high (Reuters)
UniCredit woes, profit pain hurt bank capital plans (Reuters)

Date	Country	Title	Summary
Jan 04, 2012	US	Consulting firm claims Volcker Rule May Cost Investors $315bn	The US consulting firm Oliver Wyman this week reported that investors in US corporate bonds may suffer a $315bn market-to-market loss when the Volcker Rule is implemented. The losses could

			result from limits on proprietary trading at US banks that would reduce market liquidity across asset classes. For the same reason, US corporations could also face higher costs of borrowing. According to the report's findings, if a 5% decrease in liquidity in corporate bond markets occurs, investors could suffer mark-to-market losses of $90bn while corporate borrowers could see a 16bps rise in corporate bond yields; if liquidity in corporate bond markets were to decrease by 15%, investors could suffer losses of $315bn while corporate borrowers could see a 55bps increase in yields. The study also concluded that investors may face a $4bn increase in transaction costs, while US banks are facing a potential fall in revenues and profits. However, the research has a few limitations as its estimates were based on an academic paper on corporate bond liquidity from 2005 to 2009. In addition, the research did not factor in the liquidity provided by non-bank entities which are expected to fill the void left by banks in market-making activities. **Read More**: Volcker Rule May Cost Investors $315bn (FT)
Jan 04, 2012	Spain	Spain banks required to set aside €50bn new bank provisions	The Spanish government expects its banks to allocate €50bn in additional provisions for bad property loans, which amounts to about 4% of Spain's GDP and exceeds estimates by bankers. This comes after Spanish banks already covered a third of bad property loans with provisions. According to the Bank of Spain, about €176bn out of €338bn property-related assets are bad loans, substandard loans, or repossessed properties. Reflecting the deterioration in Spanish banks' credit outlooks since the onset of its property crisis, RMI CRI's 1-year PD for Spanish banks rose 32.2bps to 60.4bps on January 06, compared to a low of 28.2bps right before the sub-prime crisis in June 2007. The additional provision is aimed at reducing any further state aid Spanish banks may require, in order to ease the budgetary burden on the Spanish government. The government has already spent €21bn, some of which is repayable, to bail out Spanish banks. Meanwhile, markets are speculating that the government could be planning a state-funded bad bank which would purchase non-performing assets from banks. However, consolidation in the banking industry is also being advocated, especially by stronger Spanish banks. **Read more:** Spain sees €50bn of new bank provisions (FT)
Jan 04, 2012	US	Kodak Readies Bankruptcy Filing; Shares Plunge Below 50 Cents	Eastman Kodak, a former blue chip imaging company, is preparing to file for bankruptcy. Kodak will file for Chapter 11 should it fail to sell portfolio of1000 patents, worth $3bn, to boost its liquidity. The company is in talks with potential lenders for $1bn of debtor-in-possession (DIP) financing if it files for bankruptcy. Even if Kodak were able to sell its portfolio of patents, it could only delay the bankruptcy filing for a month or two. In past decades, Kodak was the leader in the imaging industry, and had a near monopoly in the US. Since the advent of digital imaging, Kodak has been unable to adapt to the new competitive environment. Kodak now faces a cash crunch and posted an operating loss of

			$174mn on September 30, its fourth consecutive quarterly loss. As Kodak struggles on the brink of bankruptcy, its 1-year PD has soared to 2620bps on January 6 2012, from a low of 180bps in last January. **Read more:** Kodak Readies Bankruptcy Filing: Shares Plunge Below 50 Cents (Fox Business) Kodak edges toward bankruptcy (Channel News Asia)
Dec 28, 2011	US	Funding Gap Doubles for US Corporate Pensions	According to Credit Suisse, the funding gap of US corporate pension plans almost doubled in 2011. The bank estimated that pension plan assets at S&P 500 companies have decreased to 74% of estimated liabilities at the end of 2011, leaving a $450bn funding deficit. This compares to a modest surplus at the end of 2007 and an estimated deficit of $250bn at the beginning of 2011. Poor stock market performance and a decrease in bond yields, prevented pension plan performance from keeping up with rising liabilities. Falling bond yields diminish the discount factor used in pension plans, and increase the present value of liabilities. While regulations state that companies are required to counteract any shortfall in funding over seven years, US authorities have previously exempted companies from funding pension deficits in times of market stress. To make up for the shortfall, some companies could turn to debt markets as a viable option to close pension funding gaps, due to current low interest rates. **Read More**: Funding Gap Doubles for US Corporate Pensions (CNBC)
Jan 02, 2012	India	RBI releases Basel III draft guidelines, as state-owned banks face capital infusion	Indian banks could face problems meeting capital requirements under the Basel III draft guidelines the Reserve Bank of India released on December 29. If the draft paper is accepted as is, Indian banks will have to maintain a core Tier 1 capital ratio of at least 7% from January 2013, with total capital of at least 9% of risk weighted assets (RWAs). Banks must also maintain a capital conservation buffer of 2.5% of RWAs, in the form of Common Equity, from April 2014. The RBI believes banks already have sufficient capital to meet the new standards. Indian banks must have a core Tier 1 capital ratio of at least 6% under current RBI rules. However, changes in what is considered core Tier 1 capital could be the biggest challenge facing Indian banks. Growth of RWAs in line with economic growth could require Indian banks to mobilize additional capital. In related news, the Indian government plans to maintain the core Tier 1 capital ratio of state-owned banks at 8% and is considering preferential placements of equity. The government provided $3.82bn in capital support in FY2010-2011 and $1.14bn has already provided this financial year. The Indian Finance Ministry informed banks that future capital support would depend on their financial and functional efficiency. **Read more:** Banks look to comply to Basel III guidelines (Reuters) RBI Releases Draft Guidelines on Basel III Capital Regulations (RBI) Lenders not worried, say capital conservation is key (Business Standard) Capital infusion in public sector banks to be finalized soon (The Economic Times)

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