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Weekly Credit Brief **July 1 - July 7**

Espirito Santo's woes spark systemic risk fears among its affiliates

Fears were sparked among investors for companies affiliated with Espirito Santo International (ESI) after an audit check by Bank of Portugal in May found ESI to be in a "serious financial condition" and irregularities in its accounts. ESI owns Espirito Santo Financial Group (ESFG), which in turn holds a 25% stake in Lisbon-based lender, Banco Espirito Santo (BES). Both ESFG and BES saw their share prices hit by ESI woes ~ falling 57.8% and 45% since May respectively. While Portugal's PSI-20 index outperforms major European stock indices in the first quarter of this year, it has also seen a decline of 12.36% during the same period.

In January 2014, BES issued EUR 750mn five-year senior unsecured notes that were quickly met with a EUR 2.5bn of demand. Now, 7 months later, the story changed for the Portuguese lender as it is seeing its 5-year EUR CDS spread shot up to 322.6bps from 284bps in January 2014. Its RMI 5-year Actuarial Spread (AS) increased from 17bps in January to 30bps at the end of June but has since retraced after the Portuguese stock exchange banned short selling on BES. The RMI AS was introduced by RMI-CRI on 1 July 2014 as an alternative measure of credit risk using the RMI PD. Unlike CDS, the RMI AS is a pure measure of default risk, and is not influenced by risk premium and market liquidity. Chart 1 shows the AS of BES and its largest shareholder, Espirito Santo Financial Group (ESFG) versus the 5-year CDS of senior unsecured EUR notes of BES. *Quotes for CDS on ESFG are not available.*

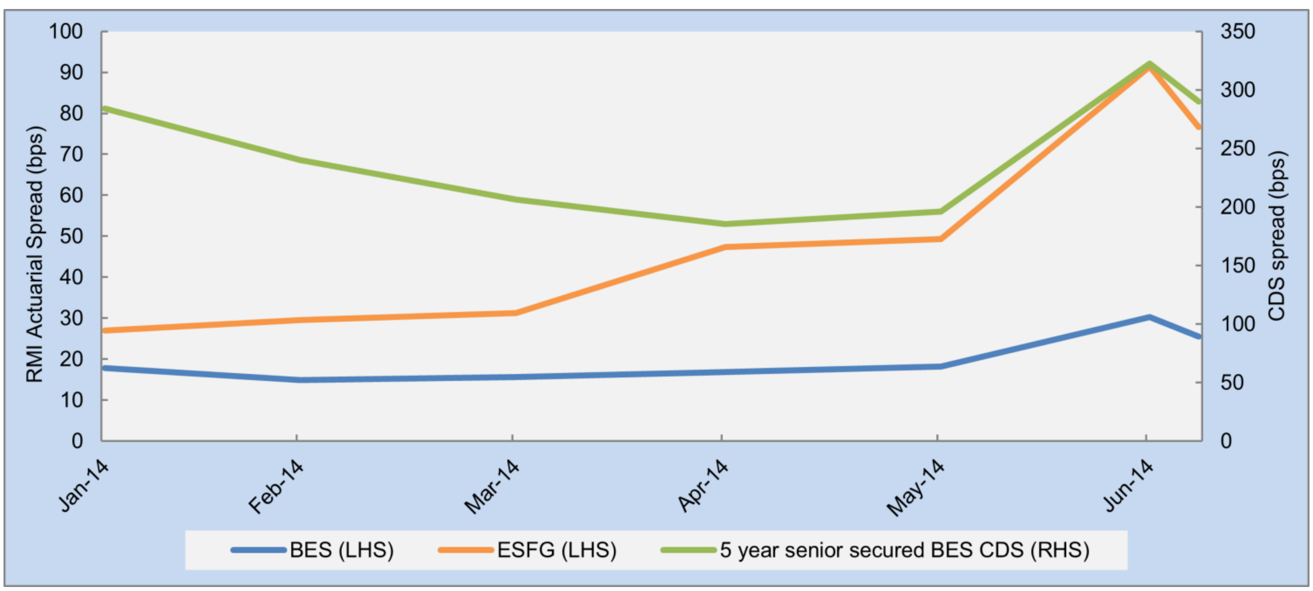

Chart 1: 5-year CDS on senior unsecured notes of BES versus RMI Actuarial Spread for BES and EFSG based on a 40% recovery rate. Note that BES CDS is a EUR denominated derivative, while RMI AS is a USD-denominated instrument. Source: *Risk Management Institute*

The bank's biggest shareholder, ESFG too has been affected by the ongoing concerns as they have guaranteed ESI's debt and took on a provision of EUR 700mn in its 2013 filing. Another related stakeholder of BES, Portugal Telecom (PT) has been dragged into an indirect exposure to the Espirito Santo group. They have a EUR 897mn investment in commercial paper issued from a unit of ESI which expires on July 15. However, the aggregate RMI 1-year PD for 44 Portuguese listed firms was not affected by the Espirito Santo saga as displayed in Chart 2.

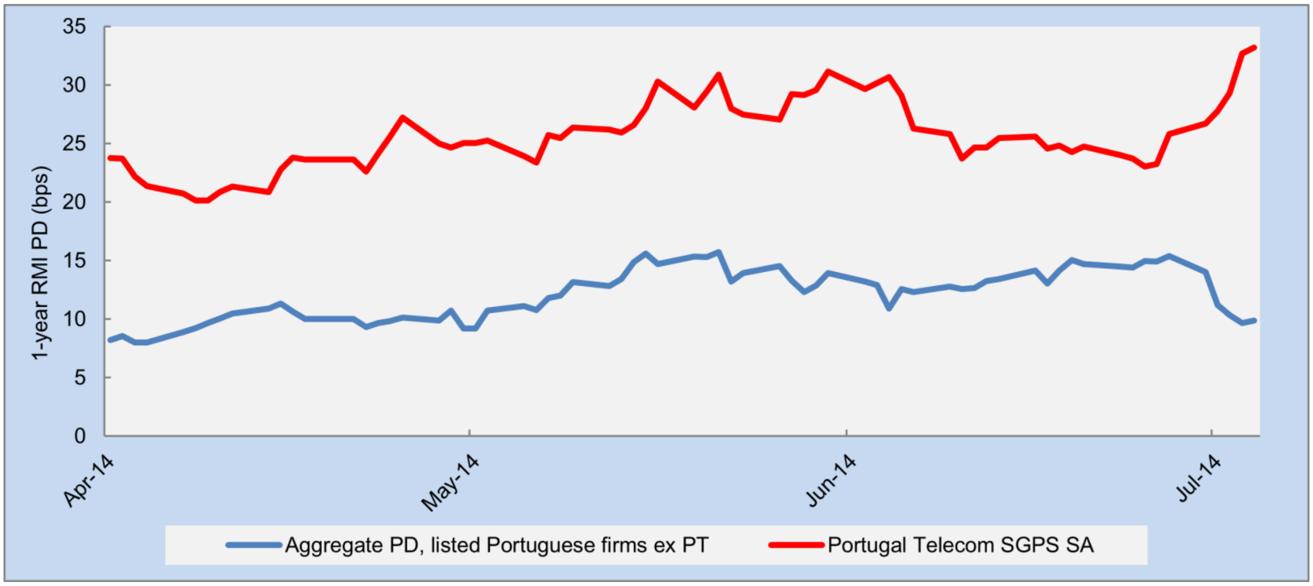

Chart 2: Chart of RMI PD for listed Portuguese firms vs Portugal Telecom. Source: *Risk Management Institute*

Last week, the Portuguese Securities Market Commission and London's Financial Conduct Authority banned investors from short selling shares of BES after its market cap declined by more than 50% over the preceding three weeks. The bank's CEO was quick to reassure investors by announcing a restructuring plan to segregate the financial and non-financial businesses of the bank, so as to ensure limited damage to existing shareholders and the continuity of the bank. On July 2, the Bank of Portugal announced that the solvency of BES is under control and the central bank has taken steps to prevent the risk of contagion from the Espirito Santo group of companies.

Credit News

Moody's says that outlook for Singapore's banking system remains negative

Jul 08. Moody's Investors Service has maintained its negative outlook on Singapore's banking system on the back of a rapid growth in their lending books – both domestic and cross-border, in recent years. The rating agency expects asset quality to deteriorate as interest rates move higher together with tighter monetary policy from the US Federal Reserve. Domestic asset price declines could also add to further strain in the financial system. Additionally, lenders with exposure to consumer loans in Malaysia and Thailand face risk from rising household indebtedness in the two neighbouring countries. As such, the credit costs for the Singaporean banks are expected to climb. Moody's expects bad loans to increase marginally over 2014-2015 from the low base of 1% as reported in 2013. (AsiaOne Business)

European banks seen facing USD 50bn more in legal expenses

Jul 07. Europe's banks are facing a further USD 50bn in legal costs as they catch up with their US counterparts. Morgan Stanley estimates that European firms could face about USD130bn of litigation and settlement costs in total. Barclays Plc and Royal Bank of Scotland face the largest increases in legal costs among European banks. Penalties for misconduct have escalated in recent weeks with France's BNP Paribas paying close to USD 9bn fine for US sanctions violation. Morgan Stanley noted that the fines are likely to hurt the industry's ability to pay dividends in the coming years. (Bloomberg)

Bankruptcies rock loan guarantors in China

Jul 07. Many Chinese loan guarantors are facing difficult operating business conditions following a rise in bankruptcies in the country. Many of these loan guarantors help to finance small and medium companies, which are not served by banks. More than 30 loan guarantors have failed in Guangdong and 12 loan guarantors have lost their licenses in Sichuan so far this year. In Wenzhou, nearly 90 percent of loan guarantors have shut their businesses. The number of failed loan guarantee businesses is expected to climb further as defaults continue to increase. (SCMP)

Bulgaria bank turbulence will not change credit rating for now

Jul 02. Standard and Poor's kept Bulgaria's sovereign credit rating unchanged despite the recent occurrence of two bank runs on Corporate Commercial Bank and First Investment Bank, as the rating agency remained confident that the Bulgarian authorities would be able to contain any contagion risk. The government has provided USD 2.3bn of credit line to the banking sector to stabilize the situation. (Reuters)

Bond anxiety in USD 1.6tn repo market as failures soar (Bloomberg)

Gowex will file for insolvency (Bloomberg)

Increasing offshore bond issues among Chinese firms (SCMP)

Regulatory Updates

Banks face added capital requirements

Jul 06. The Basel Committee on Banking Supervision (BCBS) is considering new measures to assess the riskiness of banks' assets, and also potentially end the risk-free status of government bonds. The moot point is the banks' discretion to estimate the riskiness of their own assets and that has led many to believe that banks' capital ratios are not reliable indicators of their financial health. While the discussions are at an early stage and may not result in any actual changes, the proposal is to set risk-weighting "floors" - minimum risk weights for certain classes of assets, and to treat sovereign risks in the same manner as other assets. These changes would force banks to raise billions of dollars in extra capital. (WSJ)

Obama says further changes to banking industry are needed

Jul 02. US President Obama said that more banking rules are needed beyond those listed in the Dodd Frank Act drafted four years ago. He highlighted bank trading activity as an area of concern, stating that more regulation on curbing risk taking behavior is required. Banks would have to restructure their businesses and change their compensation packages. However, the outcome for further changes to banking regulations could depend on the result of the November elections and whether Republicans take control of the Senate. (WSJ)

Microsoft taxes said to face scrutiny as EU quizzes Luxembourg (Bloomberg)

Hungary backs loan refunds as banks face mounting losses (Bloomberg)

European bankers to meet ECB on asset check update from July 8 (Bloomberg)

Italy banks able to fill potential capital gap (Bloomberg)

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