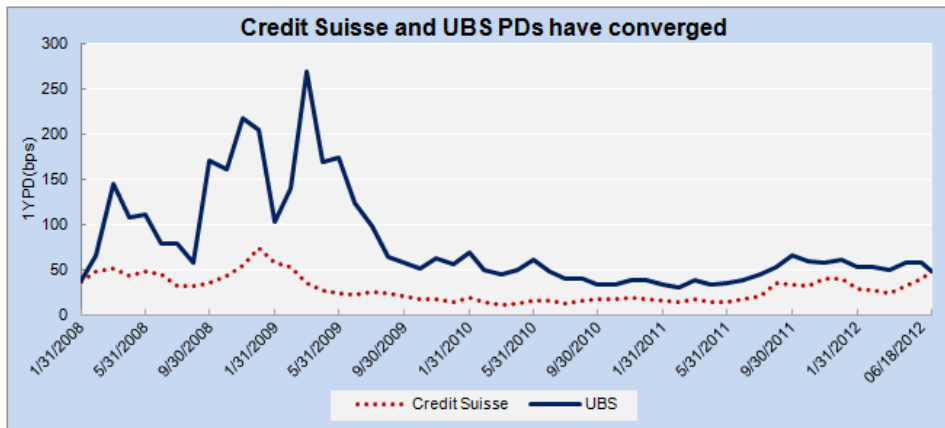


**Stories of the Week**

**SNB urges capital increases as Europe weighs on Credit Suisse, UBS**

The probability of default (PD) for Credit Suisse last week rose above that for UBS for the first time since 2008, as the Swiss National Bank (SNB) recommended that the two lenders increase their regulatory capital levels. The SNB recommended that UBS should continue to increase its loss-absorbing capital, and that Credit Suisse should significantly expand its loss-absorbing capital before the end of 2012. The recommendation came as economic conditions in Europe continue to deteriorate, and cyclical pressures in the Swiss housing market increase. The SNB warned the level of loss-absorbing capital at both banks was below that required to ensure sufficient resilience to current headwinds, but singled out Credit Suisse in particular. The CRI 1-year PD for Credit Suisse increased during the last week, due to a decrease in Credit Suisse's distance to default (DTD), or volatility adjusted leverage, and an increase in the bank's idiosyncratic risk.



The credit profile of Credit Suisse has remained remarkably favorable over the last four years when compared to UBS, as Credit Suisse suffered substantially lower losses from US structured products and reduced leverage much faster than UBS following the collapse of Lehman brothers in September 2008. Credit Suisse also avoided a bailout from the Swiss government, unlike UBS. According to RMI data, the difference in the two lenders' credit profiles was largely due to Credit Suisse's comparatively higher liquidity, profitability and DTD. Credit Suisse also maintained stronger regulatory capital levels following the collapse of Lehman, but has seen this advantage disappear in the last two years as the bank continued to make large dividend payments, while UBS increased its capital levels through dividend retention.

**Indirect exposure to Europe:** Although the two largest Swiss lenders have moderate exposures to peripheral eurozone nations, both Credit Suisse and UBS are interconnected with the rest of the European banking sector and would be subject to indirect losses if the eurozone crisis escalated significantly. In an adverse scenario envisioned by the SNB, a disorderly default of a peripheral eurozone country would increase household and corporate defaults in Europe, and contagion would spread to the US through banking and trade linkages. In such a scenario, both Credit Suisse and UBS would suffer substantial losses on their Swiss and US mortgage-based products.

**Domestic real estate remains a risk:** The SNB also warned of increasing medium-term imbalances in the Swiss real estate and mortgage markets, which would continue to build up in SNB's baseline scenario. To counter this threat, Swiss regulators may consider activating a countercyclical capital buffer of up to 2.5% of risk-weighted assets to protect Swiss banks from excessive credit growth, if imbalances reach a critical level as they did in the mid-1990s.

**Swiss banks have thinner capital buffers Basel III:** The SNB's warnings and recommendations have increased market focus on the regulatory capital levels of both Credit Suisse and UBS. Although Basel III does not fully come into effect until 2019, it has become the relevant benchmark of a bank's financial health as the previous crisis showed capital levels under current regulations overestimated the resilience of banks. In the case of the two largest Swiss banks, this overestimation is quite marked. Under prevailing Basel 2.5 rules, Credit Suisse and UBS had respective Tier 1 capital ratios of 15.6% and 18.7% as of March 2012. However, under stricter Basel III rules Credit Suisse and UBS would have respective Tier 1 ratios of 5.9% and 7.5%, according to calculations by the SNB, with Credit Suisse below the minimum 7.5% level prescribed by Swiss regulators.

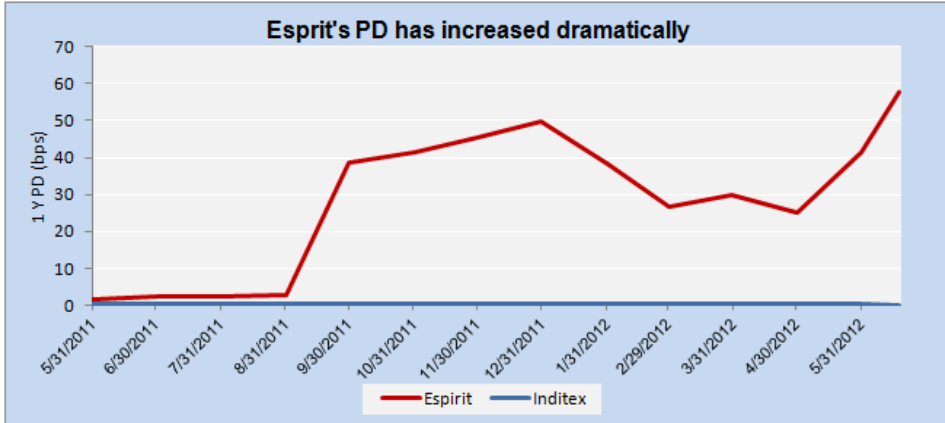
While UBS has increased current capital levels through a policy of dividend retention, market participants have realized that Credit Suisse may have difficulty raising capital organically in the current environment. Moreover, moves to increase capital levels through a reduction in risk-weighted assets would weigh on current and future earnings. This has increased speculation Credit Suisse may have to raise equity in an unfriendly market, or convert contingent debt to equity. The SNB was also concerned about consistently high leverage at both banks, and suggested each bank reduce their total balance sheets, and not just risk-weighted assets.

**Sources:**

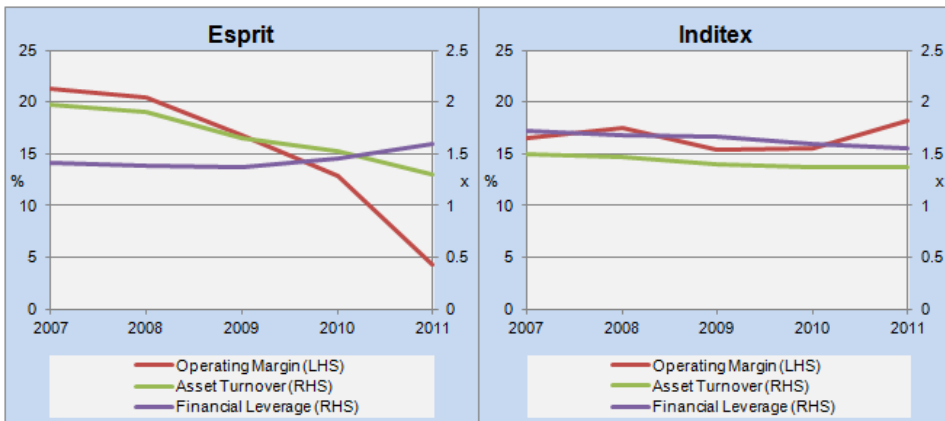
[Financial Stability Report](#) (Swiss National Bank)

**Weak fundamentals, resignations weigh on Esprit's credit outlook**

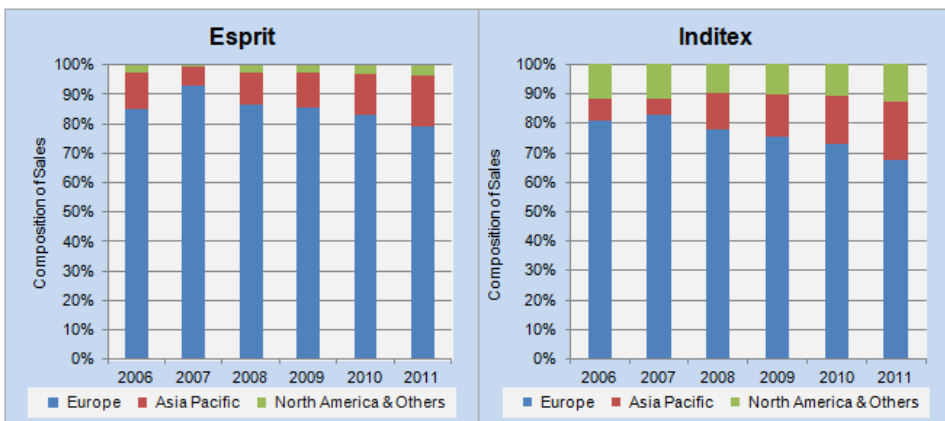
The already poor credit outlook for Esprit has further deteriorated over the past week, following the sudden resignations of the company's CEO and Chairman. Poor earnings results, especially over the past year and a weak outlook continue to weigh on investors' sentiments. CRI probability of default (PD) data reflects this weakening in credit quality, as Esprit's 1-year PD increased to 66.8bps on June 18 from a low of 3bps during August 2011. This weakening in Esprit's credit profile first became apparent around August-September 2011, according to CRI PD data.



**Challenging operating environment:** Esprit operates in an intensely competitive fashion retailing environment in which consumer tastes and preferences are difficult to judge with certainty. Unlike its key competitors, such as H&M and Inditex-owned Zara, it is seen as being behind the curve in terms of pushing fashion trends. Coupled with its higher pricing amidst a highly challenging industry, Esprit's sales have been declining, from HKD \$37.2bn in 2008 to HKD \$33.8bn in 2011. Its operating margin has also declined over this period, from 20.4% to 4.3%, while ROE fell from 46.3% to 4.7% during the same period.



In addition, the European debt crisis has hit the company hard, as Esprit has about 80% of its net sales area in Europe, which accounted for about 80% of its revenues. The weakened operating environment in Europe, coupled with the declining Euro has had a detrimental effect on the company's performance, as Esprit struggled to fend off stiff competition from its key competitors.



**Restructuring plan:** CEO Ronald van der Vis was hired in 2009 to revive the Esprit brand. In Esprit's 2011 annual report, he noted that the company faced challenges stemming from historical underinvestment in the company's network of stores and a limited geographic reach. To revive the brand, he embarked on a number of

bold initiatives. These initiatives included implementing a global refurbishment plan to revitalize all of Esprit's stores, and investing in a global media campaign aimed at accelerating Esprit's expansion in fast-growing markets like China. In addition, he introduced a series of measures to enhance product creation and ensure relevance with prevailing fashion trends.

The implementation of the whole turnaround project was estimated to require an investment of approximately HKD \$18.0bn over the next 4 years. Esprit projected that a successful execution of the turnaround strategy would result in substantially higher sales growth and healthier profit margins of 15% by 2015. While these turnaround plans do appear positive, they will take time, heavy monetary investments, and management expertise to be executed properly. As it is, Esprit's cash flow from operating activities declined sharply, from HKD \$5.4m in 2010 to HKD \$1.8m in 2011.

**Resignation of two key members:** Esprit announced key departures in the last week : CEO Ronald van der Vis and Chairman Hans-Joachim Korber. CFO Chew Fook Aun resigned last December. This has increased market speculation that the departures were due to problems with the turnaround project. The exits also came at a time when the restructuring initiatives require intensive operational supervision. A number of the current senior executives, such as the Head of China Holly Li and Chief Product & Design Officer Melody Harris-Jensbach are new hires. Without experienced leadership, there are serious doubts about the sustainability of the restructuring plan. Combining this with the current competitive industry environment and deteriorating operating conditions in Europe, the prospects of a recovery in Esprit's credit metrics are uncertain.

In view of the aforementioned, and viewed in aggregate, Esprit's credit outlook as deteriorated markedly on weak fundamentals, exacerbated by key management resignations.

**Sources:**

[Esprit plunges as CEO quits amid push to revive earnings](#) (Bloomberg)

[Esprit plummets second day as top management quits](#) (Bloomberg)

[Esprit keeps transformation plan as top executives leave](#) (Bloomberg)

**In the News**

**ING Groep downgraded alongside other Dutch and Belgian banks**

**Jun 16.** The credit ratings of several Dutch and Belgian banking groups were downgraded by Moody's last week, with ING Groep's rating lowered to A3 from A1 and KBC Groep downgraded to Baa1 from A2. Previously Aaa-rated Rabobank was downgraded one notch to Aa2. Moody's cited higher sensitivity to a deteriorating economic environment in Europe and increased funding pressures as key reasons for the downgrades. ING Groep remains on negative outlook at Moody's, while other banking groups were changed to a stable outlook. ([Bloomberg](#))

**Credit rating downgrades for Spain and France**

**Jun 15.** Moody's cut the Spanish sovereign credit rating by three notches to Baa3 from A3, and placed the country on review for further downgrade on June 13. Moody's based this decision on a large increase in public sector debt due to the government's plan to borrow EUR 100bn from the EFSF or ESM, a sluggish economy, and increasingly restricted access to capital markets which has led to a higher dependence on ailing domestic banks for funding. In other sovereign ratings news, Egan-Jones downgraded the credit rating of France one notch to BBB+, three notches above investment grade. Egan-Jones cited a deterioration in the country's credit metrics and a higher chance the state will have to lend support to domestic banks. Moreover, French President Francois Hollande will be pressurised to keep to his pledge for more growth and less austerity, through increased government spending that may eventually damage the government's credit quality. ([Moody's](#), [Bloomberg](#))

**EU set to scrap most of forced credit-rating rotation plan**

**Jun 13.** The European Parliament is poised to discard most parts of a highly criticized rotation plan for credit ratings this week, with legislators rumored to have already reached a compromise agreement before a vote on the draft law on June 19. The final rule is believed to only require rotation of CRAs for re-securitized products, such as collateralized debt obligations. Under this rule, issuers of such securitizations would have to change CRAs every five years, but would receive a partial exemption from this rule if they used more than two CRAs. The original proposal would have required companies to rotate the CRA they use for all types of ratings every three years. In a justification for the original rule, the European Commission said that rotation would increase competition and reduce conflicts of interest in the credit rating industry. ([Bloomberg](#))