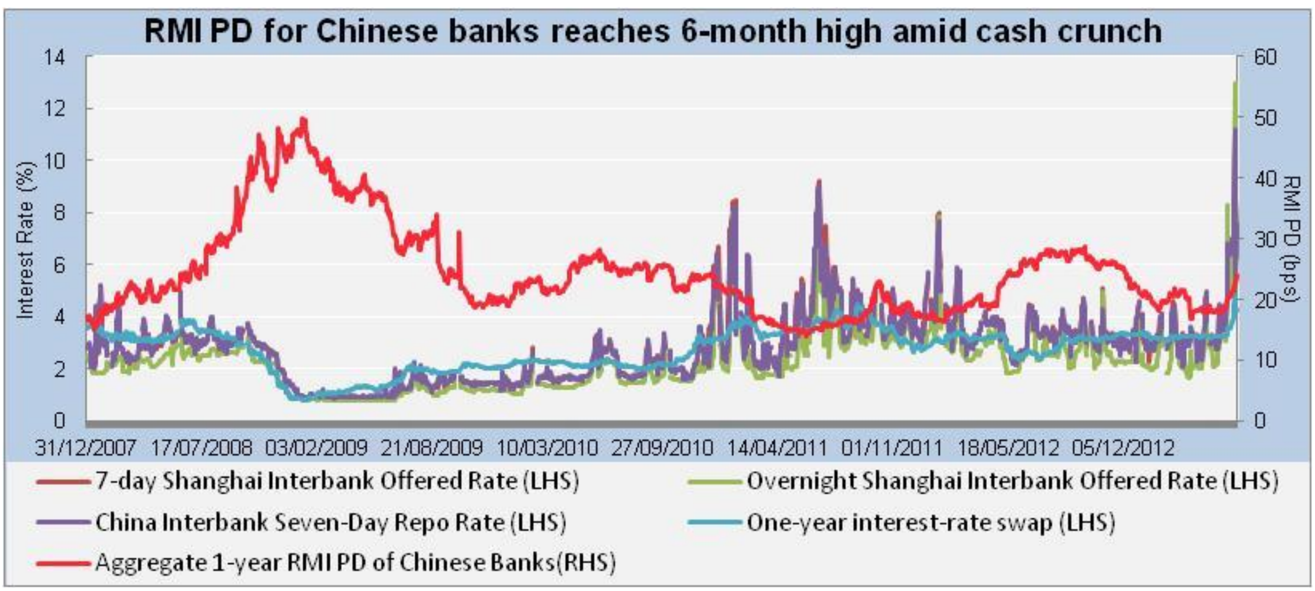
Weekly Credit Brief
Jun 18 - Jun 24 2013

**Story of the Week**

**China's central bank punishes banking system with cash crunch**

When China's Premier Li Keqiang pledged in March to reduce state control over the economy and how he would act even if it feels like "cutting one's wrist", many market participants probably did not take his words seriously, given the country's long history of government intervention in the marketplace and an economy that is thoroughly addicted to state credit. After administrative measures to curb an overheating property market and local government investments were bypassed by unregulated banking activities, the Chinese government decided to squeeze liquidity out of the banking system in order to convey their message.

The chart below shows the RMI aggregate 1-year probability of default (RMI PD) for listed China-domiciled banks against several important short-term interest rates since December 2007. The RMI PD of Chinese banks has climbed to a 6-month high amid a surge in borrowing costs since the end of May. The possibility of banks defaulting on their obligations has become much more material than before, and rumors abound that China Everbright Bank and several other banks failed to meet interbank obligations earlier this month. This observation is not unusual as banks are among the most interest-sensitive institutions. From the graph, we may also speculate that the Chinese government may have indeed restrained their control over economy, as the volatility of money market rates turned sharply higher since late 2010.




The seven-day repurchase rate, a key gauge of liquidity in China, closed at an all-time high of 11.2% on June 20, more than double where it stood at the end of May. Although the worst is probably over as benchmark money-market rates tumbled on June 21, on speculation the People's Bank of China (PBOC) had quietly added funds to the market, interbank conditions remained tight on June 24, as short-term lending rates remained more than twice the levels seen in May. Analysts have also generally maintained their view that the central bank will maintain tight monetary policy, while the government is determined to be aggressive in containing financial risks. The PBOC reiterated on Sunday that it will continue its prudent monetary policy while fine-tuning it at appropriate intervals.

Slowing foreign-capital inflows, companies withdrawing money to pay taxes and banks' needs to meet month-end regulatory capital requirements initiated the rise in interbank rates this time around. However, the reluctance of the PBOC to inject liquidity into the money market was the biggest reason for the severe cash crunch. The market may have perceived the climb in borrowing rates in early June as the customary increase in demand for cash before the Dragon Boat holiday on June 10 to June 12; most market participants had expected rates to fall back to normal after the break. Instead, the central bank sold about CNY 4bn of three-month bills on June 18 and again on June 19, effectively removing more cash from the banking system. Combined with the fact that the PBOC has stopped injecting liquidity with reverse-repurchase agreements since February, we have a clear signal that the central bank is asserting its intention to curb credit growth by the peculiar method of punishing banks with monetary policy.

Credit growth in China has been extraordinary by modern standards. Overall credit has grown to USD 23tn from USD 9tn in the five years since Lehman Brothers collapsed, spurred by a surge in unregulated lending and wealth management products. China's official Xinhua news agency, which Beijing regularly uses to make policy statements, reported on June 23 that the country's acute cash squeeze was caused by the government's crackdown on shadow banking rather than a lack of liquidity in the financial system. The news agency said that while the banks, stock market, and small to medium-sized enterprises lacked money, supply of money has been plentiful; the broad money supply M2 had expanded by 15.8% in May YoY. Xinhua added that the contrast easily shows that the seemingly ferocious cash crunch is in fact structural funding constraints caused by a misallocation of capital. "It is not that there is no money, but that the money has not reached the right places," Xinhua's commentary said.

**Sources:**

PBoC dashes hopes of China liquidity boost (FT)
China Money Rates Drop From Records After PBOC Said to Add Cash (Bloomberg)
China steps back from severe cash crunch (FT)
China's Cash Crunch Spreads (WSJ)
China Money Rates Drop From Records on PBOC Cash Boost (Bloomberg)
Fitch says China credit bubble unprecedented in modern world history (Telegraph)

**In the News**

**Death of structured notes seen as Brazil bond tax ditched**

**Jun 18.** Sales of Brazilian structured notes, which package bank bonds with derivatives to enable foreign investors to earn the higher yields on the nation's real debt while avoiding a 6% tax, have plummeted 97% to USD 40mn in June. Issuance of the credit-linked notes has practically halted after Brazilian Finance Minister Guido Mantega removed the so-called IOF tax, or tax on financial transactions, on June 5. Banks predicted that foreign investors will likely divert their funds to Brazilian local bonds, as credit-linked notes are less necessary now that the IOF tax is gone. (Bloomberg)

**Tequila crisis lessons learned before QE unwind**

**Jun 18.** Mexico's USD 158bn of peso-denominated sovereign debt has an average maturity of 8.25 years, the longest among Latin America's biggest economies, and more than developed nations including the United States, Canada and Switzerland, according to Bloomberg. The government's ability to extend maturities and lock in low rates is sheltering Mexico from the impact of the recent increase in global interest rates. 80% of Mexico's debt is in pesos, versus less than half in 1994, while the average coupon on the notes is 7.7%, the lowest ever. (Bloomberg)

**Stricter rules for credit rating agencies to enter into force**

**Jun 18.** EU rules requiring credit rating agencies (CRAs) to be more accountable for their actions entered into force on June 20. The new rules are also intended to reduce reliance on external ratings while at the same time improving the quality of the rating process. Among other new rules, CRAs will be limited to three rating changes per year on the sovereign debt of EU member states, and are to set up a calendar indicating when they will announce such changes. CRAs can be held liable if they are found to have breached these new regulations intentionally or with gross negligence. (Europa)

**Cyprus president calls for bailout overhaul to save economy**

**Jun 18.** The President of Cyprus, Nicos Anastasiades, has asked eurozone and IMF leaders to overhaul Cyprus' EUR 10bn bailout, warning that his country may not be able to meet the bailout's current terms. Anastasiades mentioned that the restructuring of Cyprus' two largest banks, which together comprise 80% of the domestic banking sector "was implemented without careful preparation" and has driven the economy into a deep recession and exacerbated unemployment. The bailout has resulted in both the restructuring of Cyprus' largest bank and the closure of its second-largest bank, with deposits exceeding EUR 100,000 in both banks seized to pay for the bailout. (Financial Times)

**US weighs doubling leverage standard for biggest banks**

**Jun 21.** US regulators are looking to double the minimum capital requirement for the largest banks to 6% of total assets. If implemented, a majority of the largest lenders would have to retain more of their earnings and withhold dividends to shareholders to build capital. By setting standards higher than Basel requirements, the US could pressure Europe into affirming its commitment to rein in risk in the financial system. The UK and Switzerland have backed the US during Basel committee discussions about the introduction of a global leverage standard. On June 20, the two countries urged their banks to improve capital positions to meet the new Basel requirements. (Bloomberg)

**Korean government to stabilize forex market**

**Jun 23.** The possibility of a large outflow of USD has prompted the South Korea government to prepare necessary steps to control the situation. After chairing a meeting with vice chiefs of four financial authorities, Strategy and Finance Vice Minister Choo Kyung-ho said that financial authorities will closely monitor the exchange market and conduct a stress test on banks to ensure there is adequate liquidity to cope with a distress event. Foreign currency liquidity at financial companies will be closely monitored and fewer long-term state bonds will be issued to minimize market volatility. Swift market stabilization measures will be undertaken in the event that the exchange rate volatility increases. (The Korea Times)

**Australia bonds extend rout on Fed outlook; Aussie hits 2010 low**

**Jun 24.** The largest sell-off in Australian government bonds since 2001 sent the yield on 10-year bonds above 4%, the highest level in 14 months, on chances that the US Federal Reserve will end its unprecedented monetary stimulus earlier than expected. The AUD fell to the lowest level against the USD since September 2010, buying 0.9182 USD on June 24. The spread between 3-year and 10-year Australian government bonds widened the most since February 2010, ahead of the Reserve Bank of Australia's policy meeting next week. (Bloomberg)

**Indonesia bond risk drops most since 2011 as fuel price raised**

**Jun 24.** The subsidized-fuel price increase by the Indonesian government last week drove down the cost of insuring its sovereign debt against default, as the five-year credit-default swaps on Indonesian bonds fell 24bps to 243 on June 21 in New York, according to CMA. Gasoline and diesel prices rose by 44 and 22%, respectively. Analysts expect the lower subsidy costs to keep the budget deficit below the legal limit of 3%. An improved trade balance as a result of lower oil imports will also bolster the INR, Finance Minister Chatib Basri said. (Bloomberg)

**World's worst real estate bonds targeted in crunch**

**Jun 24.** China's builders have been the world's worst-performing real-estate bonds this quarter as Premier Li Keqiang allowed a record cash crunch to rebalance the economy away from property investment. USD-denominated notes sold by Chinese developers have lost 4.1% this quarter, the most since the three months ended September 30, 2011 and the worst among peers in major economies. That marks a reversal after the debt topped 2012 rankings with a 22% return. China is seeking to tighten control on real-estate lending and expand property-tax trials to more cities after a three-year campaign failed to damp prices. (Bloomberg)

**Credit market rout may force US IG issuers to do more legwork** (Reuters)

**Increasing bond yields risk debt spiral in US, Japan, BIS says** (Bloomberg)

**Five banks must raise USD 21.2bn in new capital, BOE says** (Bloomberg)

**IMF to suspend aid payments to Greece unless bailout hole plugged** (Financial Times)

**Bernanke says Fed on course to end asset buying in 2014** (Bloomberg)

**Lawmakers warn ratings firms about new debt products** (WSJ)

**Moody's: Malaysia's rating outlook stable, but with rising public debt** (The Star)

**India funding strain grows as Fed outlook hurts rupee** (Bloomberg)

**Rising interest rates could hit bank capitalizations hard: report** (MarketWatch)

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