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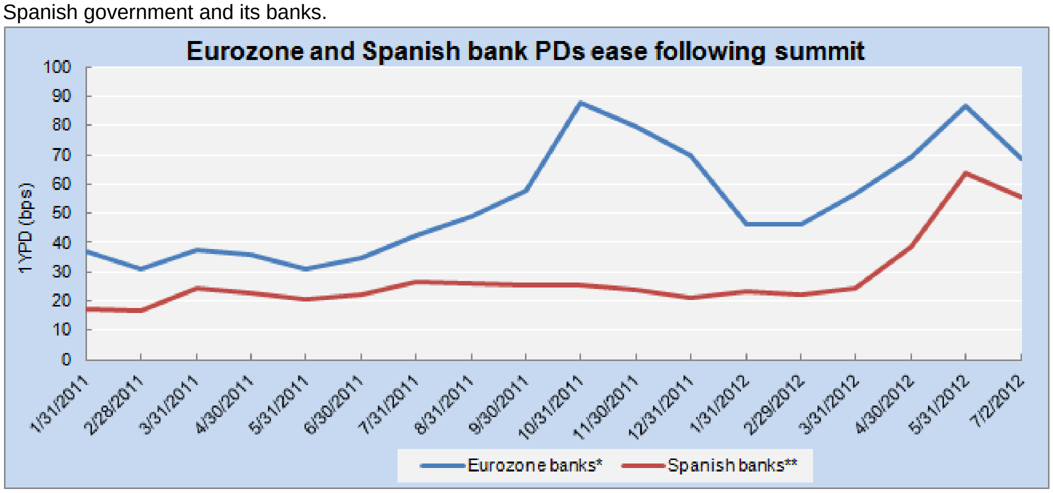
Weekly Credit Brief

Jun 26 - Jul 2 2012

Story of the Week

EU summit results a positive for eurozone banks as aid requests increase

The aggregate RMI probability of default (PD) for eurozone banks fell following last week's EU summit, after eurozone leaders reached a number of key agreements on a future banking union within the single currency bloc. This followed the approval by EU leaders of bank-related aid requests from the Spanish and Cypriot governments earlier in the week. The ECB is expected to complement the measures announced at the summit with further monetary easing policies. These factors have also contributed to an easing in the aggregate RMI PD for Spanish banks, as agreements reached at the EU summit alleviated concerns about the increasing linkages between the Spanish government and its banks.

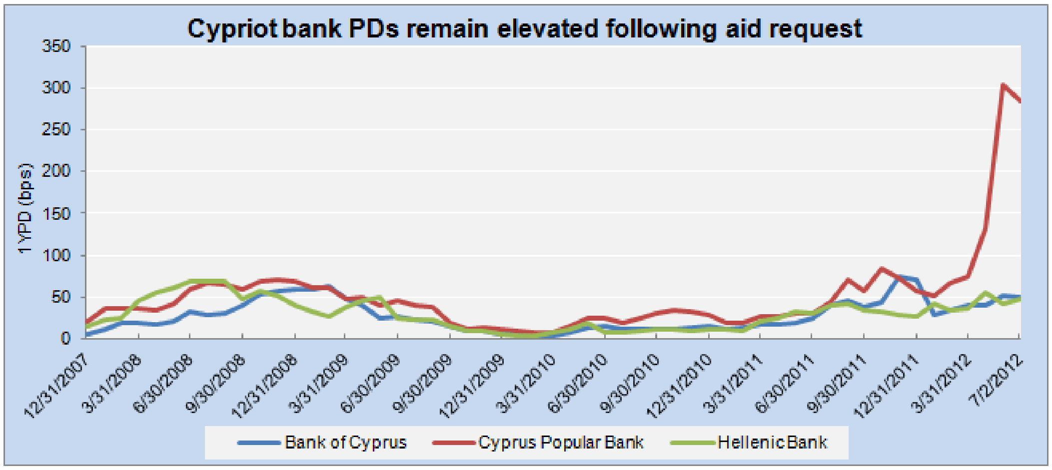


A landmark agreement: The agreement will allow the European Stability Mechanism (ESM), the eurozone's EUR 500bn bailout fund, to recapitalize ailing banks directly without significantly increasing the debt of struggling peripheral eurozone governments such as Spain. However, this will only occur after the establishment of a banking supervisory body run by the ECB. In the meantime, Spanish banks will receive aid from the European Financial Stability Facility (EFSF), with the loans being transferred to the ESM in the future, without gaining seniority status. The former has eased concerns amongst creditors of the Spanish government and banks, although market participants may remain wary after the ECB claimed immunity status during the Greek sovereign debt restructuring in March.

Eurozone leaders also agreed that funds from the ESM and the EFSF can be used flexibly to buy bonds issued by euozone nations to drive down sovereign borrowing costs. This is also a positive for eurozone banks, as yields on their bonds have become increasingly correlated with their respective sovereigns. Furthermore, it appears calls from Northern eurozone nations such as Finland for collateral to back emergency loans were rejected at the EU summit.

ECB easing: Market participants expect the ECB will cut its benchmark lending rate to a record low of 0.75% in the coming weeks, based on a past history of ECB monetary stimulus following political progress during the sovereign debt crisis. The ECB is also expected to cut its key deposit rate, to encourage banks to lend surplus funds instead of parking money at the ECB. This follows changes to the ECB's eligible collateral rules last month, which allowed eurozone banks to post bonds with credit ratings down to BBB as collateral with ECB approval and appropriate valuation haircuts. When combined, the measures should increase liquidity in the eurosystem and ease pressure on banks struggling to raise funds while sovereign yields remain high.

Cypriot Banks: Last week Cyprus became the fifth eurozone nation to apply for an international bailout, with the nation seeking an emergency loan to support Cypriot banks paralyzed by losses on Greek bonds. Listed Cypriot banks recorded EUR 5bn in losses during 2011, leading to regulatory capital shortfalls that require government support. Popular Bank needs EUR 1.8bn of support, while Bank of Cyprus requires EUR 500mn. Some estimates place total support needed by Cypriot banks at almost EUR 6bn. In late-2011 the RMI PDs for Cypriot banks reached levels not seen since 2008, and have remained elevated since then due to concerns about potential write downs related to Greek bonds and domestic loan impairments. A large spike in the PD for Cyprus Popular Bank reflects a EUR 3.6bn loss in 2011 and weak earnings results for Q1 2012.



Following the aid request, the Governor of the Central Bank of Cyprus, Panicos Demetriades, called for Cypriot banks to reduce financial links to other economies, and transform their Greek businesses into minor subsidiaries in an effort to reduce future risk to the Cypriot economy. Listed Cypriot banks held EUR 80.2bn in assets at the end of 2011, 4.5 times Cypriot GDP in 2011.

* The aggregate PD for eurozone banks includes Greek banks. The individual PDs of the latter group remain the highest amongst eurozone banks, explaining the higher PD for eurozone banks relative to Spanish banks.
** The aggregate PD for Spanish banks excludes Caja de Ahorros del Mediterraneo and Banco de Valencia, as these banks have effectively become wards of the Spanish government.

Sources:
Euroarea summit statement (European Council)
ECB takes further measures to increase collateral availability for counterparties (European Central Bank)
Cypriot banks must ringfence Greek risk (Reuters)

In the News
Barclays fined by UK, US for falsifying rates **Jun 28:** The UK's second largest bank Barclays was fined GBP 290mn by UK and US regulators last week after the bank admitted to the submission of false Libor, Euribor and yen Libor rates that were favorable to its traders. Barclays traders attempted to manipulate the rates, making almost daily requests to rate submitters from mid-2005 through 2009. In addition, pressure to preserve the bank's reputation during the global financial crisis resulted in senior managers requesting lower Libor submissions, as Barclay's was submitting rates significantly higher than peers at that time. Citigroup, RBS, UBS, Lloyds and HSBC are also currently under investigation for manipulation of Libor rates. (Bloomberg)
Germany downgraded by Egan-Jones; Commerzbank exits shipping business **Jun 26:** Upstart credit rating agency (CRA) Egan-Jones cut the German sovereign rating to A+ from AA-, and retained a negative outlook on the country. Egan-Jones stated that Germany will be left with a large amount of uncollectible receivables going forward as peripheral eurozone nations seek more lenient bailout terms. Elsewhere in German credit markets, Commerzbank announced it would wind-down operations in several key business sectors, due to market uncertainty and increased capital and liquidity requirements under incoming Basel III regulations. Commerzbank will close its commercial real estate and shipping businesses, and transfer EUR 172bn of related loans to a restructuring unit aimed at reducing non-core assets. (CNBC, WSJ)
Rating agencies losing clout in Asia **Jun 28:** Unrated bond issues by well-known companies in Hong Kong have surged in the last year, due to increasing demand for debt securities from private bank investors. This suggests unrated deals are no longer an exception in Asia, with the pricing of unrated deals by larger issuers in the last year similar to rated deals. In related news, Indian Corporate Affairs Minister Veerappa Moily criticized global CRAs for making

use of political parameters in sovereign credit analysis, arguing CRA methodologies should be confined to economic analysis. Major CRAs have recently revised India's credit outlook to negative; the country is currently rated on the cusp of investment grade. (Reuters, The Economic Times)

Asian banks target Australia

Jun 27: Some of the largest Chinese banks have increased their presence in Australian syndicated loan markets, as European lenders halved their exposures to Australian markets in the first half of 2012. Syndicated loans involving several different banks are the most common form of financing for large mining and enegy projects in Australia, which require large capital outlays. Japanese banks have also increased their presence in the market since the beginning of the year. Furthermore, one of Japan's mega-banks is planning to break into the Australian home loan market. The bank in question may use cheap funding from Japanese deposit pools to undercut interest rates offered by the highly profitable big four Australian banks. (The Australian, Australian Financial Review)

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