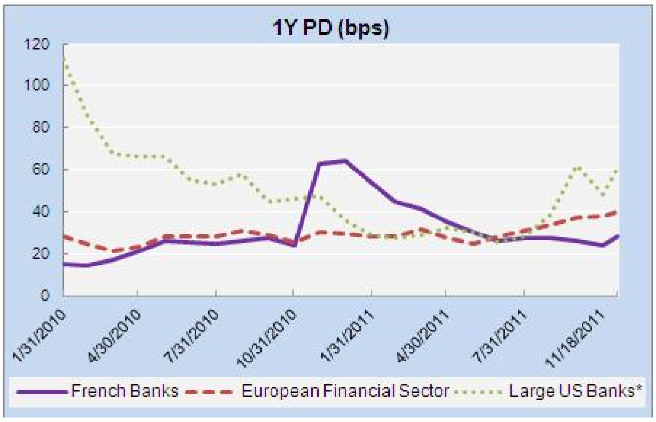
NUS National University of Singapore
RMI Advancing Risk Management for Singapore and Beyond

Weekly Credit Brief
Nov 13– Nov 19 2011

Story of the Week:
Systemic risk increases as European debt contagion spreads

Eurozone sovereign credit markets exhibited signs of increasing crisis contagion last week, as a mass sell-off of sovereign debt by concerned investors pushed sovereign yields up beyond peripheral countries. The spreads between yields of 10-year German bunds and 10-year government debts issued by core Eurozone countries such as Austria, Finland and the Netherlands approached their respective record highs in the Euro era last week. Yields on 10-year Italian debt ranged between 6.6% and 7% last week, while the Spanish government paid almost 7% on a 10-year bond issuance on November 18. France paid 50bps more than the previous month on two debt issuances the same day, with the spread between 10-year French sovereigns and German bunds reaching 200bps on Thursday morning.



ECB collateral requirements prompted Eurozone banks to increasingly rely on liquidity swaps to access ECB funding. Liquidity swaps allow banks to transfer illiquid and riskier assets to investment banks and insurers and receive liquid assets such as government bonds in exchange, which can then be used as collateral to access ECB funding. The increasing use of liquidity swaps led to concerns about the stability of the European financial system and prompted some European regulators to warn of increasing systemic risk. According to RMI's default forecast model, the 1-year probability of default (PD) for the European financial sector has risen by 11.3bps to 39.8bps on November 18, from this year's low of 24.8bps on May 31.

The increase in Italian sovereign yields is a major problem for French banks, with $901.5bn of Italian debt on their balance sheets. Reflecting market concerns, spreads of the credit default swaps (CDSs) on 5-year bonds issued by BNP Paribus rose 34.45bps to 309.75bps on November 18, from 275.31bps on November 14, while CDSs on debt issued by Société Générale rose 21.06bps to 374.16bps on November 18, from 353.10bps on November 14. The 1-year PD for the French banking sector rose 3.8bps to 28bps on November 18, from 24.2bps on October 31.

A report published by Fitch Ratings on November 16 has raised concerns that US banks remain highly exposed to the European debt crisis, although the largest US banks* have recently reduced exposures to peripheral Eurozone countries. Fitch believes these exposures are largely covered by margin and collateral requirements, or hedged with CDS. However, the report expresses concerns that CDS hedges used by US banks may be ineffective, especially if 'voluntary' debt haircuts on Greek debt, designed to avoid CDS triggers, sets a precedent for other Eurozone defaults. With this in mind, Fitch has raised the possibility of a future negative rating movement on the US banking sector. The average 1-year PD for the six largest US banks* increased 35.1bps to 60.7bps on November 18 from 25.6bps on June 30. Note that the aggregate PD of these US banks has been higher than French banks for the recent months. This could be due to the inclusion of Bank of America whose PD has increased significantly following its second-quarter losses and recent lawsuits.

*Bank of America, CitiGroup, Goldman Sachs, JPMorgan Chase, Morgan Stanley & Wells Fargo

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Italian Bond Yields Climb to 7%, French Debt Slides as Bond Rout Deepens (Bloomberg)
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Banks Face Funding Stress (WSJ)
In numbers: Italy's importance to the eurozone (FT)
Bank Stress Gauges Signal Pain Lasting Through End of 2011 (Bloomberg)
U.S. Banks Face Contagion Risk From Europe Crisis, Fitch Says (Bloomberg)
JPMorgan Joins Goldman Keeping Italy Derivatives Risk in Dark (Bloomberg)
US Banks - European Exposure (Fitch Ratings)

Date	Country	Title	Summary
Nov 17, 2011	Germany	German Public Bank's Ratings Cut by Moody's on Aid Outlook	Moody's Investors Service on Wednesday downgraded the senior debt and deposit ratings of 10 German banks, after factoring in changes in its assumptions about the amount of government support the banks would receive if required. Moody's further stated that restrictions on the provision of support, due to strict conditions set by the European Commission (EC), was another reason for the downgrade.

			According to Moody's, the downgrades were not caused by how the 12 Landesbanken, or public-sector banks, could be affected by the euro zone's ongoing sovereign debt crisis. The downgrades were mainly due to rules passed in Germany, and the restrictions on support by the EC,that reduced the likelihood of the banks receiving external support. **Read more:** Moody's Cuts 10 German Bank Ratings After Adjusting Support Assumptions (WSJ) German Landesbanken Ratings Cut by Moody's on Aid Outlook (Bloomberg Businessweek)
Nov 18, 2011	Denmark	Denmark Steps Up Mortgage Asset Defense Amid Liquidity Curbs	The Association of Danish Mortgage Banks is lobbying the EC to allow Danish mortgage banks to hold their own mortgage bonds and use these covered bonds to meet liquidity requirements. The Danish mortgage bonds are high quality covered bonds, and possess higher credit ratings than majority of Eurozone sovereign debt. This proposal is in addition to the European Banking Authority's toughened treatment of mortgage bonds where banks are required to assign higher risk weighting to the mortgage bonds they hold, resulting in higher capital requirements. Although the EC is likely to make concessions and allow Danish mortgage banks to hold unlimited number of mortgage bonds issued by other banks, the Danish mortgage industry remains concerned. It is worried that preventing banks from using their own mortgage bonds could negatively impact the industry, preventing homeowner refinancing and prepayment services offered by banks. In addition, Danish banks will likely pass on higher funding costs to households and businesses. **Read more:** Denmark Steps Up Mortgage Asset Defense Amid Liquidity Curbs (Bloomberg) EBA Mortgage Asset Bias Bodes Ill for Denmark, Jensen Says (Bloomberg)
Nov 16, 2011	Taiwan	Taiwan banks invoke market disruption clauses	Several Taiwanese banks have started to invoke market disruption clauses to pass on their rising funding costs to customers. This month, a Chinese industrial glassmaker firm was forced to accept a higher interest rate under such a clause on a HK$1.1bn syndicated loan from 13 banks, most of which are Taiwanese. The actual interest rate, though, was not revealed due to confidentiality arrangement. Banks are reluctant to invoke such clauses as invocation requires them to reveal their true funding costs. The banks' decision to invoke such clauses could signal an increase in funding pressures. Meanwhile, corporate companies in Asia are also facing rising borrowing costs. At the beginning of this year, Hong Kong's strongest companies paid 100bps over Hibor to borrow funds for 5 years.. As the Eurozone debt crisis deepens, these companies now need to pay around 200bps to borrow funds for less than 5 years. **Read more:** Taiwan banks invoke market disruption clauses (FT)
Nov 17, 2011	Australia	Australia dips its toe into covered bonds	ANZ Bank and Westpac Bank sold $1.25bn and $1bn covered bonds respectively last week. Covered bonds are collateralized by dedicated assets and provide protection for bond investors in the event of bankruptcy. This advantage over unsecured debts allows issuers to raise funds with lower costs compared to unsecured bonds. According to ANZ, the bank paid 60bps less than the price they would expectto pay on senior unsecured debt. The 1-year aggregate PD for the Australian banking sector was 91.2bps on September 30. After the Australian parliament passed the legislation on covered bonds in October, the PD lowered to 66.6bps on October 31, and was relatively unchanged at 68.5bps on November 18. Westpac expects its covered bonds to receive AAA ratings from both Moody's and Fitch, compared with the Aa2 rating of its unsecured debts. Concerns about volatile unsecured bond markets have contributed to increasing worldwide support for covered bonds. However, in countries like US and Australia,

			regulators remain worried about increasing asset encumbrance from these covered bond issuances. In addressing this concern, Australia legislators imposed an 8% ceiling on the domestic bank assets that can be pledged for covered bonds. **Read more:** Australia dips its toe into covered bonds (FT) New Issue-ANZ Banking Group sells $1.25 bln in notes (Reuters) New Issue-Westpac Banking Corp sells $1 bln in bonds (Reuters)
Nov 15, 2011	China	IMF Warns On Chinese Financial System	In its first report on the Chinese financial sector, the IMF suggested the sector now faces a gradual increase in vulnerabilities. The report also highlighted the needs to ease restrictions on banks, exchange rates and interest rates by the Chinese government. In addition, the IMF warned of risks stemming from potential defaults on infrastructure projects, increasing shadow banking activities, and bubbles in the real estate market. The IMF said that some of the risks were a result of three decades of complex financial reform, but admitted the report was hindered by limited access to data. The People's Bank of China (PBOC), China's central bank, responded with a statement that the IMF report was not comprehensive or objective enough, and some recommendations did not match market realities. The PBOC emphasized the progress China has made in reforming its currency, banks and financial sector. **Read more:** IMF Warns On Chinese Financial System (FT)

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