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Weekly Credit Brief

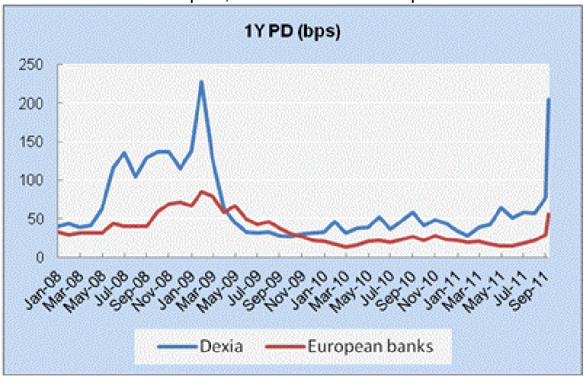
Oct 2 – Oct 8 2011

Story of the Week:

European officials discussing bank recapitalization plans

Finance ministers of the eurozone countries are considering coordinated efforts to bolster the capital base of banks in the region amid increasing concerns about the banks' funding and capital positions. In Germany, officials are contemplating a system of backstops whereby bank shareholders will inject capital into the banks needing help, followed by the national government and the last the EFSF rescue fund. While details of the plan are still being discussed, the European Banking Authority is examining the possibility of raising capital requirements for banks that passed last summer's stress test. It is also identifying the financial institutions to be included in any coordinated recapitalization plan. Meanwhile, European officials acknowledge that European, especially German banks are better capitalized than they were in the 2008-09 crisis.

Franco-Belgian bank Dexia, which has been under severe pressures lately due to its reliance on short-term financing, unveiled a reorganization plan this week. Under this plan, Dexia will sell its profitable businesses, including its asset management division and its Turkish lending subsidiary DenizBank, to support its toxic holdings of sovereign and municipal debts. A "bad bank" with at least €125bn of assets would be established and guaranteed by the French and Belgian governments. The French authorities are also discussing with two French banks CDC and La Banque Postale whether the banks should acquire the public-financing arm with €80bn of Dexia assets. Dexia holds a total of €3.5bn of Greek sovereign debts and €15bn of Italian debts.



Following the announced support by France and Belgium governments, negative sentiment has spilled over to the countries' sovereign bond and CDS markets. The yield of Belgian 10-year bonds saw a surge of nearly 20bps to 3.8% on Tuesday, according to Bloomberg. Although the yield of French bonds of similar maturity was unchanged, the spread between it and the German bund rose 8bps. The 5-year CDS spread for French government bonds increased 17bps to 206bps, while that of Belgian bonds jumped 20bps to 292bps.

According to RMI's default forecast model, the 1-year probability of default (PD) for Dexia skyrocketed 127bps to 204bps on Oct 7 from the end of last month. That is the highest level since Feb 28, 2008, when the PD reached its financial crisis peak of 227bps. Meanwhile, the 1-year aggregate PD for European banking sector increased significantly to 55bps on Oct 7 from 29bps on Sept 30.

Read More:

EU examines bank rescue plan (FT)
Merkel willing to recapitalise banks (FT)
EU's Barroso wants coordinated bank recapitalization (Reuters)
Dexia Set for Restructuring (WSJ)
France and Belgium give backing to Dexia (FT)
Dexia Worries Weigh On Belgium, French Sovereign Bonds (WSJ)

Date	Country	Title	Summary
Oct 7, 2011	UK	UK's Financial Firms Downgraded by Moody's Rating Agency	Moody's downgraded 12 UK financial firms including Lloyds, RBS and Santander UK on concern about lack of government support. This downgrade is separated into three categories: RBS and Lloyds are considered most likely to get support from the government, Santander UK and the other three are moderately likely, while the rest seven institutions are considered not at all likely to get support. RBS said it was disappointed to see such downgrade while Lloyds believed that it had minimum impact on its funding costs. While the Chancellor George Osborne said the downgrade was understandable, he was confident that the British Banks are well-capitalized. HSBC, Barclays and Standard Chartered are not included in this rating cut. **Read More:** UK's Financial Firms Downgraded By Moody's Rating Agency (BBC News)
Oct 6, 2011	China	Credit Swaps on Chinese	The size of outstanding CDS on Chinese sovereign debts has grown sharply recently, with its net value soaring to $8.3bn, a

		Debt Surge on Slowdown Fears	two-year high and the 10th largest in the world this week. It is a huge difference from what it was two years ago, which was only the world's 227th largest at that time. Concerns about the possibility of China's housing market crash and economic slowdown has contributed to the increase in demand for China CDS. Europe's slowdown is reinforcing such fears as Europe is China's key export market. According to RMI's default forecast model, the 1-year PD for Chinese public firms increased to 145bps on Oct 7 from 122bps at the end of April. **Read More**: Credit Swaps on Chinese Debt Surge on Slowdown Fears (CNBC)
Oct 3, 2011	Japan	Tepco Warned Over $112 Billion Funding Shortfall	According to the Japanese government panel, Tokyo Electronic Power (Tepco), is probably facing a ¥8,600bn ($112bn) funding shortfall over the coming decade in the worst case scenario. TEPCO has been suffering heavy financial burden since the accident in March. In May, it reported losses of ¥1,250bn, the largest annual loss for a non-financial companies. As suggested by the government panel, the company aims to solve the financial problem through a range of methods, from asset sales, cost-cutting, raising electronic rates in Tokyo, to requesting debt waivers or debt-to-equity swap. However, the rate hike needs government approval and banks are unwilling to write down debts. Even though Japanese government is trying to keep Tepco from financial collapse, the total costs of nuclear plant site repair and compensations to victims remain unclear, and will probably have to be shared by taxpayers, customers and TEPCO investors. According to RMI's default forecast model, the 1-year PD for Tepco reached 433bps on Oct 7, compared to 0.6bps at the end of February. **Read More:** Tepco Warned Over $112 Billion Funding Shortfall (FT)
Oct 7, 2011	Portugal	Moody's downgrades nine Portuguese banks	Citing increased asset risk resulting from their holdings of Portuguese government debt, the impact of austerity measures and the sovereign downgrade of Portugal in July, Moody's has downgraded the credit ratings of nine Portuguese banks including Banco Espírito Santo, Banco Comercial Português and Banco BPI. While the ECB is trying to strengthen the continent's financial sector and BoE is injecting £75bn more in its economy, Moody's downgraded nine Portuguese Banks. Except for Banco Português de Negócios all the other banks are on negative outlook. Weak economic growth in Portugal, Government austerity measures, liquidity strains due to lack of access to wholesale funding, and banks holding Portuguese debt were the reasons cited for the downgrade. According to RMI's default forecast model, the 1-year PD for Portuguese financial sector soared to 114.8bps on Oct 7, compared to 15.3bps at the end of this January. **Read more:** Moody's downgrades nine Portuguese banks (FT)
Oct 5, 2011	Europe	Italy's and Spain's credit ratings downgraded	Moody's on Tuesday cut Italy's government bond ratings by three notches, making the ratings on par with S&P's. Both rating agencies maintained negative outlook on Italy. The reasons for this downgrade were vulnerable market conditions and political uncertainty. Moody's pointed out that investors' risk appetite for highly indebted European sovereign borrowers was deteriorating. This would severely limit Italy's borrowing capacity in the public debt market. While Moody's saw no immediate need to downgrade those

			Aaa-rated countries, it warned other euro-nations with lower ratings might suffer from contagion effects of the regions' debt crisis and have their ratings cut. Separately, Fitch downgraded Spain from AA+ to AA- on Friday with negative outlook, on concern about Spain's sizeable deficit, high net external debt and the weak economic recovery. **Read more:** Moody's cuts Italy's credit ratings (WSJ) European nations face downgrade, Moody's says (Bloomberg) Fitch Downgrades Spain's Credit Rating (Fox News)
Oct 4, 2011	Europe & US	Junk bond price gap points to European distress	The spread between the prices of dollar-denominated European high-yield bonds and its euro- denominated counterparts bearing similar risks has widened to an abnormally high level. Theoretically, the differences should only be a few points to erase the opportunity of arbitrage. The widening spread reflected the increasing concern over European financial market's distress. It was partially due to investors concerns about the volatile market condition and Euro's depreciation. **Read more:** Junk bond price gap points to European distress (FT)
Oct 6, 2011	Ireland	Strong revival in Irish bond markets	Amid the rising concerns over Greece and Italy sovereign debts, Ireland seemed to have restored investors' confidence as its 10-year government bond yield has fallen to 7.70%, down from its peak of 14.07% on July 18. Though the current yield level was still considered unsustainable without rescue loans, Ireland has seen signs of recovery. With tax and deficits on track, its export and growth outlook was improving while unemployment rate was falling. However, the falling housing prices and fragile banking sector remained as critical obstacles in its recovery path. According to Eurostat, Ireland's debt as a percentage of GDP has increased from 24.8% in 2006 to 96.2% in 2010. This indicated that Ireland still had a long way to go in its fiscal reform. **Read more:** Strong revival in Irish bond markets (FT)
Oct 6, 2011	UK and Eurozone	Liquidity support by BOE and ECB	The Bank of England(BoE) has voted to increase its quantitative easing (QE) program by £75bn to £275bn (SGD 130 billion) as the central bank recognizes that the UK economy is vulnerable to repercussions from the ongoing Eurozone debt crisis. This is the first time since 2009 that the bank has increased the scale of its QE program. Separately, the ECB has also extended its policy of providing unlimited liquidity to the Eurozone banks and plans to include 12-month loans this month and 13-month loans from December. Both the BoE and the ECB has left interest rates unchanged, at 0.5 and 1.5%, respectively. **Read more:** Bank of England increases QE by £75bn (FT) Bank of England pumps economy with 75 billion pound of new cash (Economic Times) UK financial firms downgraded by Moody's rating agency (BBC)