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

Weekly Credit Brief
Oct 23 – Oct 29 2011

Story of the Week

EU to impose mandatory recapitalization on banks

European leaders agreed Thursday on a plan to reduce Greece's debt and prevent further contagion of the European debt crisis within the Union. Under the agreement, private investors including banks, insurance companies and investment funds will take a "voluntary" 50% haircut on holdings of Greek bond. The European Financial Stability Facility (EFSF) will be expanded through guarantees to a sum of around €1tr, and the EU will boost the capital of struggling Euro zone banks by €106bn. Debt reduction reforms in Italy, the third largest EU economy, are a key component of the agreement, and a10-year debt issuance by the Italian government on Friday will be a litmus test of investor sentiment. Markets remain skeptical of the plan, with a lack of details being a chief concern. Italy paid the highest price on a debt issuance since joining the Euro zone, with spread between Italian and German bonds widening to 378bps at an end September sale.

European banks, after revaluing sovereign debts at market rate, will have until June to increase their holdings of "highest quality" capital to 9% under the agreement. Banks who cannot raise new capital privately or from national governments will borrow money from the EFSF as a last resort. The European Central Bank will continue to assist banks with their short-term funding needs, by providing loans and continuing a sovereign debt purchase program. Interestingly, French banks have increased their borrowing from the ECB by more than their Spanish and Italian counterparts in recent weeks. This could signal contagion effects that financial stress in the Euro zone financial system might be affecting larger Euro zone economies. According to RMI's default forecast model, the 1-year probability of default (PD) for European banks increased to 52.7bps on October 28 from 47.3bps on September 30.

Some Spanish banks are reluctant to accept state funds, with larger Euro zone banks preferring to raise capital by shrinking their balance sheets. This is done by selling assets and reducing lending activities. A large reduction in lending by European banks may reduce economic activity in the region, leading to a weakening in the credit outlook for European companies. The 1-year PD for European firms increased to 34.9bps on October 28 from its low of 27.5bps on February 28.

Read more:
EU pushes banks to find extra Euro 106bn by June (FT)
Italy's borrowing costs soar at debt sale (FT)
European banks face recapitalizations (WSJ)
EU Forges Greek Bond Deal (WSJ)
Banks buoyant as capital needs clarified (FT)
Europe Bolsters Crisis-Fighting Tools, Pledging Details to Come (FT)
French financials lead increase in borrowing from the ECB(FT)

Date	Country	Title	Summary
Oct 27, 2011	Europe	Credit Crunch in Central and Eastern Europe	Banking in Central and Eastern Europe is dominated by western European banks such as UniCredit SpA and Erste Group Bank AG and therefore local units are likely to receive less support as these lenders may have to focus on recapitalizing themselves, making it difficult to fund their units in the region. The big Western European banks raised funds centrally, and provided their Central and Eastern European (CEE) subsidiaries with ample fund that allows them to borrow more cheaply than they would have been able had they tried to access the international funding markets. However, with the growing credit problems in the Eurozone, these banks might not be able to provide enough funds for this region, therefore slowing growth. Earlier this month, the European bank for reconstruction and redevelopment halved its 2012 growth forecast for the eight CEE countries, largely because of the reduction in credit growth. The CEE has to find an alternative to the current system. This region has relied heavily on foreign owned banks and with underdeveloped capital markets and national banking systems, they may have to deal with lack of funds and slower growth. **Read more:** Dismantling Banking's New Iron Curtain (WSJ) Euro Crisis Fix May Threaten Lifeline for East Europe Banks (Bloomberg)
Oct 25, 2011	Denmark	Danish banking crisis entices buyers	Denmark's banking sector is expected to see further consolidation. A number of troubled banks may have to seek acquirers to avoid being wound down under the country's bail-in laws. According to Standard and Poor's, as many as 15 banks

		seeking cheap targets	could turn insolvent in the following three years as a result of non-performing loans. Danish regulators in September passed a bill that helped banks side-step one of European Union's toughest resolution frameworks. According to the new rules, the Financial Supervisory Authority will assist troubled lenders in cleaning up their balance sheets and arranging takeover deals. While shareholders will lose their stakes, senior debts will still be upheld. The law is intended to invite investors back to the Nordic country, as banks have seen the funding market closed to them since February, when Amagerbanken A/S's failure led to EU's first senior creditor losses. Max Bank earlier this month was the first insolvent lender to test such a law. The deal was successful after Sparekassen Sjaelland A/S agreed to buy the failed bank's healthy assets at the last minute. **Read more:** Danish Banking Crisis Entices Buyers Seeking Cheap Targets (Bloomberg) Denmark Tells Banks Facing Insolvency to Prepare Auction Plans (Bloomberg)
Oct 23, 2011	Europe	Banks share risks with investors	A growing number of banks, particularly those in Europe, are striking deals with private equity groups, hedge funds and insurance companies in an effort to preserve their precious regulatory capital. These equity groups and hedge funds are providing the banks with special targeted transactions, writing partial guarantees for the assets on the bank's balance sheets through securitization to help them share their risks for lucrative fees Such transactions increase the liquidity of the banks by decreasing the amount they must hold for reserves against potential losses. These collateral or liquidity swaps allow banks to borrow a large pool of high quality sovereign and other bonds. In return they put up a larger pool of mortgage bonds, infrastructure loans or other illiquid debt as a collateral which they can use for their required 'liquidity buffers' which allows insurance agencies and hedge funds receiving higher yields. The swaps have been criticized by regulators, including the UK's Financial Services Authority, for potentially increasing links within the financial system and further exposing insurance companies to systematic risk. **Read more:** Banks share risks with investors (FT)
Oct 25, 2011	US	Fitch rejects third of complex debt package	Fitch has denied a third of 849 structured products since it established a "transaction filtering committee" in 2009. While 74 deals were rejected immediately because of their 'fundamental weaknesses', others needed improvements in minor issues, such as a lack of documentation, before they can be rated. Among them, many were resecuritization transactions, which involve re-packaging downgraded products to receive a better rating. Fitch's move highlighted credit rating agencies' efforts to rebuild their reputation. Both Moody's and S&P have sought to limit their activities in the resecuritization market, and impose stricter criteria in assigning ratings. The three firms have been severely criticized as a number of initially triple-A rated MBSs were downgraded during the financial crisis. **Read more:** Fitch rejects third of complex debt packages (FT) Rating agencies: Conflicts of interest denied (FT)
Oct 28, 2011	Global	Shadow Banking	Including the euro zone, shadow banking sector is estimated at $60 trillion. It is larger than the peak of $50 trillion in 2007 and is about the half size of traditional banks. Regulators put growing efforts to rein in since the crisis but are afraid that more activities move out of the traditional banking sector in order to escape the tighter regulations. Financial Stability Board(FSB) said it would monitor the sector annually and will publish studies on this sector in the next 18 months with other global regulators. Though United States has the largest shadow banking sector, its market share has declined since

			2007. FSB would take a close look on entities that do maturity transformation, a process where institutions take in short term money and lend it out for longer periods and assess the systemic risks arising from Shadow Banking. **Read more:** Shadow Banking (Bloomberg)
Oct 24, 2011	Global	Corporate Outlook: Big Companies Can Borrow While Small Ones Struggle	Corporate bond sales are improving after financial crisis of 2008 as companies turn to the debt market for alternative financing. However, the Euro zone crisis and global economy led the global bond issuance to the lowest level since late 2008, while the average fixed-rate borrowing cost for investment grade companies fell to 4.23% from 4.36%, resulting in the hike of debt sales outpaced the lows of 2008, as investors consider stronger corporates a safe heaven. On the other hand, the average coupon for fixed-rate junk bonds jumped to 9.15% with limited issuance and sales volume. In general bankers are cautiously optimistic on the outlook of corpporate debt. **Read more:** Corporate Outlook: Big Companies Can Borrow While Small Ones Struggle (FT)
Oct 24, 2011	Asia	Rising cost of credit hits Asian companies	Asian companies have observed rising costs of financing even for those companies with high credit quality. Export-Import Bank of Korea had to pay a two and a half percentage premium over treasuries for the $1 trillion it raised in September despite its quasi-sovereign nature. The rising financing cost has left junk-rated companies completely out of the credit market since June. Large investment houses have been withdrawing capital from Asia due to redemptions in their domestic US and European markets. If this trend of capital outflow continues in the region, Asia's attractiveness for capital will be undermined. However, many Asian companies have built up sufficient cash reserves so the impact of the current credit drought may be limited. **Read more:** Rising cost of credit hits Asian companies (FT)
Oct 25, 2011	India	Reserve Bank of India hikes interest rates by 25bps; free saving banks rate	The Reserve Bank of India raised interest rates on Tuesday for the 13th successive time and announced the immediate deregulation of savings bank deposit rates. Before the announcement, savings rates were at 4%. The deregulation of savings rates is expected to raise the cost of funds and squeeze margins. A private lender, Yes Bank, raised its savings rate immediately by 200bps to 6%. In addition, this reform is expected to cause profits to drop up to 50% at public sector banks as margins decrease. **Read More:** RBI hikes interest rates by 25 bps; frees savings bank rate (Economic Times) India Central Bank Deregulates Savings Deposit Rate; Cost of Funds to Rise (CNBC) Shake-up for Indian banks as savings rates are set free (FT)
Oct 27, 2011	Brazil	Credit growth shows Brazil's resilience	Brazil's credit growth in September reached a yearly high, showing its resilience of domestic demand. The credit boost was partly attributed to the depreciation of Brazilian real against US dollar. This increased Brazil's dollar loans in local currency terms. More importantly, Brazilian government ceased its tightening cycle at the end of August and cut the benchmark interest rate by 100 bps to 11.5% due to concerns over economic growth. However, the monetary stimulus might lead to a resurgence of inflation which stayed at 7.12% year-on-year in October.

			Read more: Credit growth shows Brazil's resilience (FT)

Published weekly by Risk Management Institute, NUS