

**Story of the Week:**

**Lawsuit adds to US and European banks' array of problems**

The US and European banking sector, which already are facing a multitude of problems, could face further pressures arising from a US lawsuit by the Federal Housing Finance Agency in New York and Connecticut courts on 2 September. The lawsuit, which accused a total of 17 banks from the US and Europe of mis-selling mortgage-backed securities to Fannie Mae and Freddie Mac before the financial crisis, exposes the banks to a payout that could amount to \$30bn. Moreover, there is speculation that more lawsuits could happen. Following the news, the S&P Banks Index fell 7 points to 110 on 6 September from 117 on 1 September while the STOXX 600 Banks Index dropped 17 points to 127 from 144 over the same period. These banks saw noticeable jumps in their 1-year probability of default (PD) based on RMI's default forecast model. Bank of America, JPMorgan Chase, Wells Fargo and Citigroup, who are among the banks being sued, all experienced increases in their 1-year PD. The biggest increase is for Bank of America, whose 1-year PD rose about 8bps from 31 August to 54bps on 9 September; while the smallest increase is for Wells Fargo, whose 1-year PD increased about 2bps to 13.1bps over the same period.

Some signs of stress have lately begun to emerge for the US financial sector's long-term funding. According to the Barclays Capital bond index, spreads on US financial institutions' dollar-denominated bonds over risk-free rates increased to 282bps on 22 August, a level comparable to October 2009. In spite of the pressure on long-term financing, short-term funding such as inter-bank lending showed little sign of stress. According to Federal Reserve data, the fed fund effective rate was 0.09% for most of the last week, slightly lower than August's average level of 0.097%. Furthermore, the discount window borrowing was US\$11.6bn for the week ending 7 September, slightly lower than August's average of US\$11.8bn, indicating that US banks' needs for cash from the Fed is not very pressing. The US banks' 1-year aggregate PD fluctuated narrowly in the range of 72 to 74bps between 2 September and 8 September, compared to 82bps on 31 August.

In contrast with the US, Europe saw an increasing strain on interbank liquidity. Usage of the ECB's deposit facility surged to €172bn on 8 September, the highest level so far in 2011. This indicated that eurozone banks are increasingly hoarding cash in the central bank, accompanied by a decrease in interbank lending activities. In addition, US money market funds have been reducing credit supply to eurozone banks, adding to the funding pressures among the region's banks. European banks also are facing challenges in their long-term financing with their net issuance of bank debt excluding covered bonds standing at negative \$41bn so far this year (Dealogic data). The 1-year aggregate PD of European banks rose to about 46bps as of 8 September, compared to about 43bps on 31 August.

**Read More:**

- [U.S. Lawsuit Pressures Bank Shares](#) (WSJ)
- [Wave of lawsuits engulfs troubled lenders](#) (FT)
- [US banks' bond spreads widen on capital fears](#) (FT)
- [US money market blow for eurozone](#) (FT)
- [European banks face funding problems](#) (FT)

Date	Country	Title	Summary
6 Sept, 2011	Australia & Global	Australia eyes early Basel III adoption	<p>The Australian Prudential Regulation Authority (APRA), which supervises the country's financial institutions, proposed a timeline for banks to adopt Basel III's requirements ahead of the official schedule. The proposal urged Australian banks to meet the tier one capital ratio of 6% by 2013 and the capital conservation buffer of 2.5% by the beginning of 2016, two and three years earlier than agreed under Basel III respectively. Since the banking sector remains well capitalized, it will face little difficulty to comply with such a request in the short run.</p> <p>Meanwhile, it is estimated that banks' lending to consumers and businesses and their earnings can be affected by the new requirements of the "liquidity coverage ratio". Based on these concerns, the Basel committee on Banking Supervision regulators are assessing potential impacts of the new "liquidity coverage ratio" and are considering to relax some key technical definitions in the ratio.</p> <p><b>Read more:</b>  <a href="#">Australia eyes early Basel III adoption</a> (FT)  <a href="#">Regulators poised to soften new bank rules</a> (FT)</p>
6 Sept,	China &	China Groups	As China tightened its control on its banking system's

2011	US	Fuel Growth of Shadow Banking	<p>credit supply, the shadow banking activities are growing in the country where non-financial companies with surplus cash are increasingly lending to other companies with cash needs. It is estimated that capital flows amounting to \$310bn could happen every year due to shadow banking lending.</p> <p>Many state-owned companies such as PetroChina and China Mobile set up their financial subsidiaries to lend out money. Other companies employ their assets in 'wealth management products' from trust companies and commercial banks. The same trend exists in the US as the Dodd-Frank Act raised banks' cost of lending to the middle market. Various 'shadow' banks were set up by private equity and hedge fund investors to serve this particular market niche.</p> <p><b>Read more:</b>  <a href="#">China Groups Fuel Growth of Shadow Banking</a> (FT)  <a href="#">'Shadow Banks' Move in Amid Regulatory Push</a> (FT)</p>
6 Sept, 2011	Europe	Fears grew in European debt market despite ECB action	<p>Italy saw the 11-day rise in its treasury yields came to a halt on Tuesday, as the ECB stepped in to buy additional bonds of the country. Italian 10-year yield dropped 6bps to 5.48%. Spain also benefited from the central bank's action. Its 10-year yield was down 7bps to 5.25%, a turnaround from the rise in the previous 7 consecutive days.</p> <p>However, the two countries continued to pay high premium of 364bps and 341bps respectively over the corresponding German bunds. They had paid interest rates similar to that of Germany prior to the sovereign debt crisis.</p> <p>Meanwhile, Greece's 10-year yield surged 46bps to 19.78%. Its 5-year credit default swap jumped to a record high of 3001bps on Thursday, a one-day increase of 196 bps.</p> <p>The market fears are based on concern about these governments' ability to implement necessary fiscal austerity measures and private sector's participation in the second Greek bailout. The uncertainty surrounding the expansion of EFSF's power for future bailout also adds to such fears.</p> <p><b>Read more:</b>  <a href="#">Italian debt markets break losing streak</a> (FT)  <a href="#">Greek Credit Swaps Surge to Record, Signal 91% Chance of Default</a> (Bloomberg)  <a href="#">Fears rise again over Europe debt crisis</a> (FT)  <a href="#">Nerves fray as Italian yields continue to rise</a> (FT)</p>
6 Sept, 2011	UK	SMEs Tap Customers with Retail Bonds	<p>As total bank lending to small companies continued to decline, many of these companies eyed retail bonds as a possible solution for their funding needs.</p> <p>These retail bonds sold directly to the company's customers without a formal registration with regulator. Despite the absence of a secondary market, retail bonds have been well received by investors. However, these smaller companies inherited higher default risk. Individual investors would also face a higher tax burden for investing in non-exchange listed bonds.</p> <p><b>Read More:</b>  <a href="#">SMEs Tap Customers with Retail Bonds</a> (FT)  <a href="#">Analysts Caution on Mini Bonds</a> (FT)</p>
8 Sept, 2011	Europe & US	Yankees and Sterling Aid Euro Corporate Revival	<p>Yankee issues, which recently have been quite inactive due to the ongoing European sovereign debt crisis, saw some revival last week. Some Yankees and Sterling issuances last week were well received by investors. Several investment grade Euro-denominated bond were issued after six weeks without any issuance.</p> <p>The US corporate bond market remained strong, with historically low borrowing costs. This can be attributed to historically low 10-year US treasury yield that saw its yields falling to 1.91% on Thursday. More Yankee issues are expected to happen in the market to capitalize on the low borrowing cost. At the same time,</p>

			<p>Sterling market offers higher spread and longer maturity, generating substantial demand under the current low yield environment.</p> <p><b>Read more:</b>  <a href="#">Yankees and Sterling Aid Euro Corporate Revival</a> (Reuters)  <a href="#">Europe's Corporate Bond Market Reopens</a> (FT)  <a href="#">US Treasury Yields Approach 60-year Low</a> (FT)</p>
5 Sept, 2011	US	Gap in US Pension Plans Hits \$388bn	<p>Many large US companies have been facing funding gap problems with their defined-benefit pension plans since 2008, which leave a current total deficit of \$388bn. The current gap is a result of the recent feeble stock market and historically low interest rates.</p> <p>These pension plans are mainly investing in the stock market while bearing the liability to pay out fixed sum to scheme participants. Plunging stock market led to huge losses in the assets owned by these plans. In addition, when the historically low interest rate is used to discount future pension obligations, liabilities shot up. These defined-benefit schemes may need to be restructured such as switching from traditional equity market to the less volatile bond market.</p> <p><b>Read More:</b>  <a href="#">Gap in US Pension Plans Hits \$388bn</a> (FT)</p>
9 Sept, 2011	US	Downgrades of Fannie Mae and Freddie Mac issued debts	<p>S&amp;P downgraded debts issued by mortgage financiers Fannie Mae and Freddie Mac on 9 September. Last month, S&amp;P cut the AAA rating of the mortgage financiers Fannie Mae and Freddie Mac following the downgrade of the US, in a move that reflects the dependence of the financiers on the US Government.</p> <p>The difference of the yield on the Government Sponsored Enterprises (GSE) bonds and the US treasuries increased to its highest level since more than two years ago. The increase in the spread could possibly be attributed to uncertainties in prepayments and supply rather than concerns about the credit rating downgrade.</p> <p><b>Read More:</b>  <a href="#">S&amp;P downgrades Fannie Mae and Freddie Mac</a> (FT)  <a href="#">Fannie Mae and Freddie Mac downgraded</a> (FT)</p>