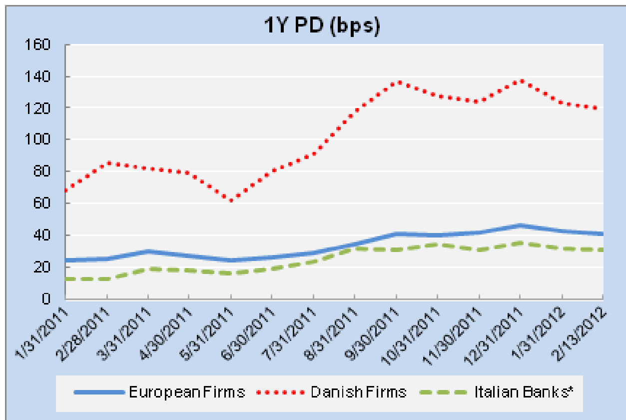
Story of the Week

European corporate defaults expected to rise while signs of optimism emerge in Greece

Greek lawmakers approved new austerity measures on February 13, which will trim the Greek 2012 budget by an additional €3.3bn. The passage of the measures is a crucial part of a €130bn aid package for Greece, which will be discussed by eurozone finance ministers on February 15. A portion of the funds will help Greece meet a €14.5bn bond repayment due in March and prevent a disorderly default. The new bill will also pave the way for a debt-relief arrangement that would cut the net present value of private-sector investors' Greek bond holdings by about 70%.



Despite the positive news, European corporate defaults are expected to increase this year. The RMI CRI's 1-year aggregate probability of default (PD) for European firms declined to 41.4bps on February 10 from 46.9bps on December 31, reflecting optimism regarding the Greek situation. However, the PD for European firms remains elevated compared to a low of 25bps last May. The deterioration in credit outlook is largely due to European banks reducing lending and increasing borrowing costs, as they try to meet tighter capital requirements by June.

Despite the European Central Bank (ECB) providing €489bn in cheap 3-year loans in December, banks have not increased lending to the real economy, with some banks instead depositing funds with the ECB. Overnight deposits at the ECB reached €528bn on January 17, the highest level since the inception of the euro in 1999. Overnight ECB deposits remained elevated at €507.9bn on February 12.

A credit crunch in Denmark has continued in the last few months. Danish regulators last year ordered banks to restate bad loans, after a review found that banks had understated write-downs. This contributed to the failure of three Danish banks, including Amagerbanken, which breached solvency requirements last February after an upward revision of its write-downs. The tighter reporting requirements have also caused Danish banks to tighten lending to businesses, as the banks recognized asset write-downs and struggled to meet stricter capital requirements. A recent proposal that would force banks to reflect decreasing property values in loan portfolios could further compound the credit squeeze. The RMI CRI's 1-year aggregate probability of default (PD) for Danish firms has risen to 123.2bps on February 10 from a low of 62.2bps last May.

Italian banks are also facing financing challenges, as yields on bonds issued by the largest Italian lenders were 508bps higher than an index of European bank yields on February 9. S&P believes Italian banks face increased external financing risks and reduced profitability, while their ability to roll over wholesale debts has been significantly impaired. The RMI CRI's 1-year aggregate probability of default (PD) for the five largest Italian banks* has risen to 31.23bps on February 13 from a low of 14.7bps last May. S&P downgraded 34 Italian Financial Institutions on February 10, a majority of which are banks, following the ratings agency's two notch downgrade of the Italian Sovereign rating to BBB+ on January 13.

* By total assets (UniCredit, Intesa Sanpaolo, Banca Monte dei Paschi di Siena, Banco Popolare and Unione di Banche Italiane)

Read More:

Greek Lawmakers Approve Austerity Bill as Athens Burns (CNBC)
Europe's Banks Reluctant to Lend to Companies in Need of Cash (New York Times)
Corporate defaults set to jump in Europe (FT)
Denmark's Credit Crunch Worsening as Retrenching Banks Spur Vicious Circle (Bloomberg)
Global Corporate Default Rate to Increase, Moody's Reports (Bloomberg)
Italian Banks Downgraded; S.&P. Cites Lending Risk (New York Times)

Date	Country	Title	Summary
Feb 12, 2012	China	China tells banks to roll over loans	Chinese banks have been ordered by their central government to roll over their holdings of local government debts. About US$1.7tn of debt was accumulated in response to the global financial crisis by Chinese provinces and cities. A majority of such debt is maturing over the next three years

			but many local governments lack the funds to repay the principle of these loans on maturity. The Chinese government last week urged banks to extend the maturities of these loans, in order to prevent a wave of massive defaults. While such measure may only forestall a surge in non-performing loans, the government hopes that the extension gives it time to address the problem. Chinese banks are said to be using two main criteria when considering debt rollovers: the viability of the investment, and consistency with government 5-year plans. There are reports that the government is also considering a direct bail-out of local governments, by assuming a majority of outstanding debt. **Read More:** China tells banks to roll over loans (FT)
Feb 6, 2012	Japan, South Korea	Sony, Panasonic Forecast Deeper Losses as South Korean Firms Dominate	Panasonic forecasted a record ¥790bn loss on February 3 for the fiscal year ending March 31. Japanese electronics manufacturers face increased risks from a strong yen, impaired production capacity due to the floods in Thailand, and increased competition from non-Japanese manufacturers. Sony and Sharp also increased loss forecasts in past weeks, as revenue from television businesses waned. Combined forecasted losses of the three Japanese manufacturers could reach ¥1.3tr for the fiscal year ending March 31. Japanese electronics manufacturers face increased competition from South Korean manufacturers, such as Samsung and LG. CDS spreads in the last month reflected a shift in market perception of electronics companies, as Japanese electronics companies face increased competition in television sales from Korean manufacturers who are supported by revenues from strong mobile device businesses. The cost of 5-year CDSs on Panasonic increased to 24,8bps above the cost of similar contracts on Samsung on February 3. The spread between Panasonic and LG Electronics CDSs decreased to 33.4bps on February 3. Panasonic CDSs have historically priced well below CDSs on debt issued by LG and Samsung. The 1-year PD for Panasonic increased almost three fold to 23.4bps on February 13 from a low of 8bps last June. The 1-year PD for LG Electronics decreased to 14.6bps on February 13 from a high of 24bps last August. The 1-year PD for Samsung Electronics has remained below 2bps since August. **Read More**: Sony, Panasonic Forecast Deeper Losses as Samsung Dominates (Bloomberg) Sony Widens Loss Forecast to $2.9 Billion on Stronger Yen, Thailand Floods (Bloomberg) Sharp sees record net loss as TV woes spur LCD cuts (Reuters)
Feb 5, 2012	Europe	Regulator to Challenge European Banks' Capital Plans	As much as half of the capital restructuring measures proposed by 30 European banks to meet the 9% core tier one capital requirement by July 31 may come under scrutiny by the European Banking Authority (EBA). Questionable tactics include changes to methodologies banks use to calculate the risk-weighting of their assets, over-confident profit projections, and the assurance of demand for asset sales. European politicians have expressed concern that forcing banks to meet the capital shortfalls identified by the stress tests could contribute to a credit crunch. The EBA plans to make sure that bank asset sales are not hurting the real economy,

			and are timed to avoid fire sales. Many European banks which are already using the internal ratings based (IRB) method for some of their assets may extend this to value the rest of their assets to reduce their risk weighting and improve capital ratios. **Read More**: Regulator to Challenge European Banks' Capital Plans (CNBC)
Feb 13, 2012	Europe	'Co-Co' Debt Finds Favor in Euro Zone	Southern European governments are encouraging their banks to issue contingent convertible bonds, which convert to equity if a bank's capital ratio falls below a certain level, in an effort to strengthen weaker banks. The so-called co-co bonds would allow indebted governments to indirectly support domestic banks. The Spanish government last month explicitly stated it would buy co-cos from its domestic banks to promote consolidation; two major Portuguese banks are expected to issue the bonds to the government in coming months to meet European capital requirements. European banking regulators have allowed co-cos to count toward bank capital ratios, as additional hybrid tier 1 capital. To be eligible, the bonds must convert the bonds into equity when a bank's core tier 1 capital ratio falls below 7%. Government purchases of co-cos can also be interpreted as a way of postponing government losses from bank bailouts. Lloyds Banking Group and privately held Rabobank previously issued co-cos in 2009 and 2010 respectively; Credit Suisse remains the only publicly traded company to have sold this type of debt. **Read More**: 'Co-Co' Debt Finds Favor in Euro Zone (WSJ)
Feb 13, 2012	Europe	Moody's Downgrades 6 Euro-Zone Nations; UK Outlook Lowered	The sovereign credit ratings of Italy, Portugal, Spain, Slovakia, Slovenia and Malta were downgraded by Moody's on February 13 due to the ongoing European debt crisis and weakened European financial markets. Notably, Spain was downgraded two notches to A3, Italy was downgraded to A2 from A3 and Portugal was downgraded to Ba3 from Ba2. Moody's also placed the UK, France and Austria on negative outlook, which means the countries risk losing their triple A ratings by Moody's in the next 12 to 18 months. This is the first time since the eurozone crisis that the UK has been placed on negative credit outlook by a major credit rating agency. Moody's cited weak macroeconomic conditions, vulnerability to the eurozone and high levels of public debt as reasons for the downward revision of the UK's credit outlook. **Read More:** Moody's Downgrades 6 Euro-Zone Nations; UK Outlook Lowered (WSJ) Moody's shifts outlook for UK and France (FT)