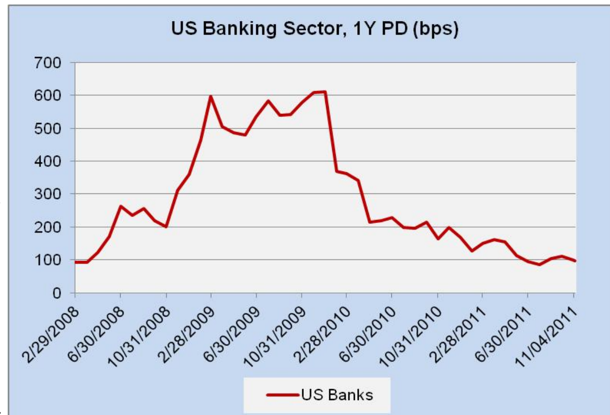
Story of the Week

As Eurpoean leaders dither, US banks remain vulnerable

The Greek Prime Minister's unexpected announcement and subsequent retraction of a public referendum to approve a second EU bail-out deal sent credit markets into turmoil last week. Italian sovereign bond yields surged to an Euro-era high of 6.4% and revealed a lack of confidence in European leaders amongst investors. A lack of progress on the funding of the European Financial Stability Facility at the G20 conference last week had created further uncertainty in financial markets



Stemming from market upheaval in Europe, the bankruptcy of MF Global Holdings last week is a distressing signal that US financial institutions are highly vulnerable to the Eurozone debt crisis. MF Global filed for Chapter 11 bankruptcy after credit downgrades led to margin calls on some of the $6.3bn in Euro zone sovereign debt the bank held. The margin calls stemmed from risky bets MF Global made on Eurozone sovereign debt, with the size of the positions being five times the firm's equity.

Although major US banks have less exposure relative to available capital, their exposure to European banks will inevitably drag them into any financial meltdown in the Eurozone. US banks' estimated direct exposures to the troubled European nations of Portugal, Ireland, Italy, Greece and Spain are disturbingly high, equal to nearly 5% of total US banking assets. Aside from the troubled Eurozone, US banks have an estimated loan exposure to German and French banks in excess of $1.2tr.

In addition, an increase in credit default swaps (CDS) sold on peripheral Eurozone sovereign debt further raises their exposure to the Eurozone. Disclosures made by US banks on these CDS exposures sum to a total of almost three times as much as their $181bn in direct lending to the five (PIIGS) countries at the end of June. This represents an increase of their exposure to peripheral Eurozone debt by 20% to $767bn in total risk from January till October. A default by a peripheral Eurozone nation, and/or the collapse of a major European bank, could trigger a wave of collateral calls from CDS counterparties, similar to problems AIG faced when the asset backed security market collapsed in 2008, except on a much larger scale. According to RMI's default forecast model, the 1-year probability of default for US banks increased to 96.8bps on November 4 from the low of 86.6bps on July 31.

Read More:
EU leaders battle to save Greece deal (FT)
For debt-laden Italy all roads lead to ECB (FT)
Italian bond yields remain stuck above 6% (FT)
MF Global Flies Bankruptcy as Broker-Dealer Unit Liquidates (Bloomberg)
Selling More CDS on Europe Debt Raises Risk for US Banks (Bloomberg)

Date	Country	Title	Summary
Nov 1, 2011	Europe	Europe's banks will find ways to recapitalize	European lenders are under pressure to raise new funds from investors, or find other ways of bolstering capital ratios, as regulators demand that they find €106bn to insulate their balance sheets against a wider debt crisis. Because of a decline in the value of debt issued by European banks, especially subordinated bonds, banks that need to raise capital may buy back their existing debt obligations at a discount and free up capital through liability management (LM) exercises. Hybrid capital, which has features of debt and equity, could be one of the prime targets for such exchanges. The European Bank Authority, which is supervising the implementation of a core tier one capital ratio of 9% for European banks, has already hinted that LM is one way of achieving that. Rather than issuing new debt or equity the banks could offer to purchase the debt at below par. Other methods banks are using to boost their capital ratios include shrinking balance sheets by reducing lending activities, or by tweaking risk weightings within regulatory guidelines when calculating their tier one capital ratio. **Read more:**

			[Battered banks look at debt rejig to boost finances](#) (FT) [Europe's banks will find ways to recapitalize](#) (FT)
Nov 3, 2011	Europe	ECB to Buy €40 billion in Eurozone	In addition to the interest rate cut announcement on Thursday, the European Central Bank (ECB) stated it would buy €40bn (US$55bn) of covered bonds from Eurozone banks, in order to boost the region's troubled economy. The ECB provided no indication of which banks it would buy bonds from. In addition, the Central Bank lowered the minimum credit rating requirement for covered bonds purchase to BBB-, allowing it more flexibility to buy debts. This threshold reduction means only short-dated covered bonds issued by Greek banks are ineligible under the program. The ECB also agreed to lend the purchased bonds to the secondary market in order to support liquidity in financial markets. **Read More**: [ECB to Buy €40bn in Eurozone](#) (FT)
Nov 4, 2011	Global	G20 names 29 banks for capital surcharge, recovery plan	The Financial Stability Board (FSB), a body made up of global regulators, announced last Friday that 29 banks require additional capital and closer surveillance, as they are an imperative part of the international financial system. The listed banks will face a 'systemic' surcharge between 1% and 2.5%, depending on their perceived importance to the global financial system. The systemic surcharge comes on top of incoming Basel III reforms requiring a minimum core tier 1 capital ratio of 7%. In addition, a list of globally systematically important financial institutions (G-SIFIs) will be reviewed each year. No bank is currently considered to be a G-SIFI, but any bank who does qualify may have their capital surcharge set at 3.5%. The nominated banks will also be required to create 'living wills' – resolution plans that allow a large bank to be quickly broken up by regulators. This rule is largely motivated by the collapse of Lehman Brothers, and other systematically important institutions in 2008, in order to reduce the effect on the real economy and the need for taxpayer bailouts. **Read more:** [Policy Measures to Address Systemically Important Financial Institutions](#) (FSB) [G20 names 29 banks for capital surcharge, recovery plan](#) (Reuters) [G20 leaders endorse 'living wills'](#) (FT)
Nov 2, 2011	US	Fitch: Basel correlation assumptions withstand crisis experience	A new report published by Fitch Ratings found that asset correlations under Basel III, which are used by banks in the internal-ratings based (IRB) approach to risk-weighting assets, generally exceed correlation values Fitch derived from credit conditions during the GFC. Basel III compliant capital ratios will therefore be able to cope with significant periods of financial stress. However, empirically derived correlations for residential mortgages exceed assumptions under Basel III, suggesting Basel assumptions do not factor in periods of high loss performance in a specific asset class. In addition, according to the report, Basel III correlation assumptions could understate the potential volatility in the credit performance of individual institutions with high concentration in specific financial products, regions or sectors during a stress period. The report also illustrated the degree to which asset correlations could vary over time, highlighting the weakness of fixed correlations under Basel III. **Read more:** [Basel III Correlations: An Empirical Analysis Reflecting the Financial Crisis](#) (Fitch Ratings) [Fitch: Basel correlation assumptions withstand crisis experience](#) (Reuters)
Nov 2, 2011	Europe & US	US Lawmakers to Propose Transaction Tax for Financial Firms	Two US lawmakers will introduce a bill to impose a transaction tax on financial firms that is similar to a recently released EU proposal. The bill will give the United States an increased role in the international debate over a transaction tax, which was included in discussions at the G20 summit last

			week. The global transaction tax is based on the Tobin Tax idea, devised by a US economist in the 1970s, is facing resistance from bank trade groups. The EU in September proposed a financial transaction tax that would take effect in 2014 and raise about $57bn euros (SGD 100bn) a year. British bankers have objected to the plan, stating that the tax will reduce the competiveness of Europe, in particular London, as a financial hub. Germany and France have led a push for global implementation. The proposed US transaction tax will be lower than the planned EU tax. US lawmakers stated that the US tax would be about 3bps per transaction, while the EU proposal called for a transaction tax of 10bps. **Read more:** US Lawmakers to Propose Transaction Tax for Financial Firms (Bloomberg) Sarkozy may make headway at G20 on transaction tax push (Reuters)
Nov 2, 2011	China	Boom in Chinese Bond Sales Masks Problems	China's bond market has grown to 20 times its size in 2006, with 503 companies issuing $137bn debts. China accounted for nine of the ten largest local currency corporate bond sales in Asia over 2011. However, market experts think that China's bond market is still very much a state sponsored market, and is not yet an efficient way to allocate capital. The expansion of the bond market in the past few years has helped Chinese firms, who have traditionally relied on loans from state-owned banks, diversify their financing sources. Currently, there are three separately-governed approval mechanisms for corporate bonds in China, and each type trades in a different market according to different rules. Markets are concerned that corporate bond yields are too closely related to bank rates set by the central government, although bond dealers in China believe that the market is steadily improving. The fact that most of the bond issuers are state-owned enterprises leads investors to assume the government will bail out insolvent firms. The problem with this situation is that it is hard to distinguish the inherent credit risk of different bonds. Investors are buoyed by increasing secondary market volumes as the market is factoring in credit risk incrementally. **Read More:** Boom in Chinese Bond Sales Masks Problems (FT)
Nov 6, 2011	Australia	Kangaroo Bond Sales Slump as Swap Flags Bounce: Australia Credit	Sales of Kangaroos bonds, debt issued in Australian dollars by foreign companies, fell to the lowest level in more than a year, as sovereign-debt troubles reduce investor demand for European debt. Over 50% of Kangaroo bonds are issued by European borrowers, who are currently facing investor demands of higher yields. However, a recent increase in the Australian dollar basis swap may draw issuers back to the market. The five-year Australian dollar basis swap, a measure of the cost of switching interest based on LIBOR payments into interest payments linked to the Australian bank bill swap rate, closed at a five-month high of 28bps on October 28, falling to 19bps in the past week. Issuers of Kangaroo bonds benefit from a higher basis swap rate, as it increases the discount of swapping bond proceeds into US dollars. When Australian companies sell debt in the US, the basis swap rises, and it drops when foreign borrowers issue Kangaroo bonds. The increase in the basis swap has made Kangaroo bonds a more competitive funding option in the last few months, with speculation that Australian banks will soon issue covered bonds placing upwards pressure on the basis swap. **Read more:** Kangaroo Bond Sales Slump as Swap Flags Bounce: Australia Credit (Bloomberg)
Nov 3,	South	South African	South African banks have proved relatively resilient to recent

2011	Africa	Banking: Set to escape the worst of the fallout	economic shocks, with senior banks citing conservative management, prudent regulation and limited exposure to banking systems in the Western Hemisphere. Not one bank failed or required government aid during the 2008-2009 financial crisis, and the four largest South African banks all presently exceed incoming Basel III reforms comfortably. Despite this, reform implementation may force changes in established funding structures. Mortgages tend to be funded with short-term institutional deposits; with Basel III cracking down on liquidity mismatches, banks will face higher funding costs. Credit risk remains, as low mortgage demand has caused South African banks to increase unsecured lending, with unsecured loans rising 61% in the 2010-2011 financial year. Although default rates have not reached dangerous levels, with household debt at almost 80% of annual income, the chances of a wave of bad loans is high. Weak corporate demand for credit means overall credit growth remains weak. **Read more:** South African Banking: Set to escape the worst of the fallout (FT)

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