

Stories of the Week

Second Greek bail-out fails to improve European financials' credit outlook

Eurozone finance ministers reached an agreement on February 21 on a second rescue package for Greece in a long-awaited move that will help the country avert a disorderly default at the end of March, when the country faces a €14.5bn coupon payment. However, a full resolution of the Greek crisis continues to be elusive, and weighs on the credit outlook of European financial companies. The RMI CRI 1-year probability of default (PD) for European financials' remains elevated, as it edged up to 41.1bps on February 27 from 39.3bps on January 31. The credit outlook for Greek companies was also little changed as a Greek default remains likely and could worsen the country's economic and financial woes. The aggregate RMI CRI 1-year PD for Greek companies increased to 134.3bps from 126.6bps over the same period.



The new deal is aimed at restoring Greece's debt sustainability and reducing the country's debt to GDP ratio to 120.5% by 2020 from the current level of 160%. Under the agreement, Greece will receive bailout loans worth €130bn from eurozone nations, and the interest rate the country pays on past loans from European member states will be reduced by 50bps. Any profits made by the ECB or European national central banks on their holdings of Greek bonds will be funneled into the Greek bailout fund. However, Greece must pay significant costs in return for this aid, including tougher austerity measures, which could exacerbate a persistent recession and compound efforts to improve the country's public finances.

In addition, Greece's private-sector creditors face an estimated 70% net present value loss on their holdings through the bond exchange programs launched on February 24. Reinforced by a collective action clause recently enacted by the Greek government, the bond exchange could threaten to unsettle investors and derail Greece's efforts to resume market financing. The increased size of Greek debt write-downs will also translate into larger losses at European financial companies.

Markets reacted negatively to the new Greek aid plan, as fears of a Greek default remain, given the country's deteriorating fundamentals. The 1-year Greek bond yield soared to 771bps on February 27, from 652bps on February 21. Investors are also worried about contagion spreading to other debt-laden eurozone economies, and European banks with sovereign exposures. Italian and Spanish 5-year CDS increased 10bps to 392bps and 8bps to 373bps respectively, over the same period. European banking shares declined as the STOXX 600 Bank index dropped to 153 on February 27, from 158 on February 21.

S&P and Fitch downgraded Greece to selective default on February 27 and 22 respectively, as both credit rating agencies expressed concern that the Greek debt exchange constitutes a distressed debt restructuring and will be coercive for private bondholders due to the recently passed collective action clause.

Sources:

- [The 'unprecedented' Greek bailout: Will it work?](#) (The Washington Post)
- [Greek debt nightmare laid bare](#) (FT)
- [Eurozone ministers back 130bn-euro bailout for Greece](#) (BBC)
- [IIF Sees Greek Orderly Debt Crisis Resolution as 'Key Challenge'](#) (Bloomberg)
- [Greece launches long-awaited debt swap offer](#) (Reuters)
- [Europe agrees to second Greek bailout](#) (WSJ)
- [S&P puts Greece in selective default](#) (FT)
- [Fitch Cuts Greek Rating, Says Debt Exchange Equals Default](#) (Forbes)

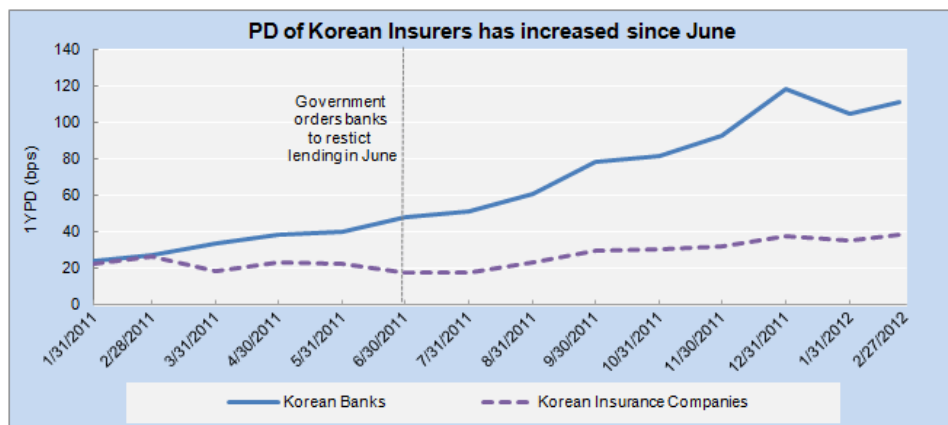
PD of South Korean financials increases, despite Government curbs on household lending

South Korean financial regulators announced February 26 that they would institute new restrictions on lending by non-bank financial companies, as household debt balloons. This follows similar measures to suppress bank lending to households in June 2011, when the government asked banks to keep household loan growth below nominal economic growth, and reduce their loan-to-deposit ratios below 100% by June 2012. In response,

consumer lending by banks decreased, but less regulated non-bank financials like mutual savings cooperatives and insurance companies expanded their lending.

In order to account for the heightened risk from household loans, insurance companies will have to increase provisions for loan losses and increase the risk weightings on household loans when calculating capital adequacy ratios. This will serve as a deterrence against further household lending growth at Korean Insurers.

Increased concern about household debt levels has placed some upward pressure on the PD for South Korean financials. Although limits on bank lending in June slowed consumer loan growth at commercial banks, the 1-year PD for Korean banks continued to rise, as Korean banks are highly dependent on European commercial paper markets. Lending by insurance companies has increased as borrowers sought loans from non-bank financials, with the 1-year aggregate PD for South Korean insurance companies more than doubled after June 2011.



The aforementioned measures to curb non-bank lending should further restrict growth in household credit, but will make it more difficult for distressed borrowers to refinance outstanding loans. South Korea's average household debt is around 160% of average annual disposable income, higher than the ratio in the US before the subprime mortgage crisis. In addition, debt-servicing costs make up a large proportion of household expenditure. According to Seoul-based Hana Institute of Finance, a majority of mortgages are variable-rate and bullet-type, which require full payment of principal on maturity. Such structures increase the risk of defaults at maturity, especially for lower-income borrowers.

Sources:

- [S.Korea says to curb lending by non-bank companies](#) (Reuters)
- [Korea to tighten household loan rules for non-bank lenders](#) (The Korea Herald)

In the News
<p>ECB Preparing to Close Liquidity Floodgates Feb 22. The European Central Bank (ECB) may end its provision of cheap long term funds after its second longer-term refinancing operation (LTRO) on February 29. It fears a number of unintended consequences including over reliance on the ECB funds by banks and governments, and rising inflation risks. (CNBC)</p>
<p>Draft Basel III provisions cushion liquidity shocks for Indian banks Feb 21. The Reserve Bank of India (RBI) published draft Basel III guidelines on Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) standards for Indian banks. The guidelines also advised on internal control procedures, minimum amounts of liquid assets, and risk monitoring systems. Although LCR and NSFR reporting will not become compulsory until 2015 and 2018 respectively, the RBI expects banks to begin Basel III supervisory reporting from June 30. (Business Standard)</p>
<p>Asian High-Yield Issuers Return Feb 23. After being shut out of international bond markets, speculative-grade Asian companies are showing signs of coming back, as low interest rates in the developed world spur investors' interests in Asian high-yield issuers. Such developments are welcomed by banks searching for more lucrative alternatives to investment-grade bonds. (WSJ)</p>
<p>Top Lenders See Asia Loan Boost Feb 23. Companies in the Asia-Pacific region are facing large increases in refinancing and M&A deals this year, supporting syndicated loan growth in the region. The expectation for such growth comes despite the cost of the loans increasing over the last year due to tightened liquidity. (Bloomberg)</p>
<p>UK and Japan warn Volcker rule poses threat to recovery Feb 22. The UK and Japan have urged the US to revise the Volcker rule. They warned that the Volcker rule could make the issuance and distribution of sovereign debt more difficult, costlier and riskier, at a time when the eurozone is struggling with the sovereign debt crisis. (FT)</p>
<p>Fitch Downgrades Commonwealth Bank, Westpac, National Australia Feb 24. Fitch Ratings downgraded three of the largest Australian banks last week, as the ratings firm believes the banks' reliance on offshore wholesale funding makes them vulnerable to swings in market</p>

confidence, relative to their international peers. All three banks were cut to AA- from AA. Fitch reaffirmed ANZ's ratings at AA-. ([Bloomberg](#))

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Contact the editor at weeklycreditbrief@nus.edu.sg