

European Doom and Gloom

Tuesday, September 20, 2011

End-game or catalyst for a turnaround?

Amid the European doom and gloom and continued German opposition to the Eurobond proposal, market hopes for the Eurozone to pull fresh rabbits out of the hat are quickly diminishing. Below we consider what are the potential scenarios:

- **Plan A: muddle-through.** A continuation of the status quo, which is for the European policymakers to believe that the economic reality is less dire than what the market is signaling, and to hold to “core” principles eg. Germany’s opposition to Eurobonds as that will be a “monetization of sovereign debt”. Bundesbank President Jens Weidmann also said an expansion of EFSF powers risks increasing the burden on “financially strong countries” and are “another big step towards a collective liability and reduce the disciplining function of capital markets without strengthening control and influence on national fiscal policies in return”.

A recent White House statement suggested that US president Obama and German Chancellor Merkel agreed that “concerted action would be needed in the months ahead to address the current economic challenges and to assure global economic recovery”. The five key central banks – ECB, Fed, BOE, BOJ and SNB did signal this willingness last week when they assured markets of USD funding across the year-end to tackle the liquidity issues for the European financial system. Beyond coordinating USD funding through swap lines, it is unclear how open the Eurozone policymakers are to taking suggestions on how to handle the crisis, as seen from the immediate rejection of US Treasury Secretary Geithner’s suggestions at the recent Eurofin meeting.

Domestically, Merkel is struggling with holding her CDU coalition together after a string of poor showings at several key state elections amid skepticism whether Greece should and could be saved, especially ahead of elections which are due in 2013. So unless we see a sharp turnaround in Germany’s stance towards the EFSF expansion, Eurobonds proposal, and establishing a Eurozone TARP-equivalent to take over the bad assets (mainly the PIIGS government debt) sitting on European banks’ books, the “muddle-through” scenario will be the default situation, which ironically adds to the risk of a crisis moment.

- **Plan B: Greece defaults.** Actually with Greece’s CDS trading above 5980 bps and the 1-year bond yielding above 100%, the markets have already priced in the likelihood of a Greek sovereign default in the imminent future. The only uncertainty is whether it will be an orderly or disorderly event. The probability of this happening may be accelerated should the troika reject Greece’s budget-reducing measures as inadequate and withhold the next €8b tranche and the second bailout package, and/or Germany’s lower house Bundestag vote down the EFSF amendments on 29 Sep, when markets take Greece, the troika and Germany to task on this. Kathamerini newspaper reported that Greek PM

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Papandreou is considering holding a referendum to whether remain or exit from the euro common currency, hoping to use the vote as a mandate for implementing austerity measures required by the troika.

As it is, there are suggestions that the German government is considering a “Plan B” to help shield banks and insurers from losses if Greece defaults. Germany’s biggest lenders and insurers owned about €17.5b of risks relating to the Greek government. Germany’s bad banks may be most at risk should Greece default, namely Hypo’s FMS Wertmanagement and WestLB’s Erste Abwicklungsanstalt who bear €8.76b and €1.21b of Greek sovereign investments and loans, which are more than half of German banks’ Greek debt. In comparison, Deutsche Bank AG and Commerzbank AG hold a combined €3.35b, according to reports compiled Bloomberg.

Nevertheless, Germany’s banking system may fare better off than that for France in the case of a Greek default - BIS data showed that German banks’ foreign claims and other potential exposures on an ultimate risk basis vis-à-vis Greece (both private and public sector) stood at US\$23.8b at end-March, of which 59% was to the public sector. French banks, in contrast, had US\$56.9b exposure to Greek debt, of which 24% was in government claims. France also have not set up bad banks to hold their Greek investments. Therefore, Credit Agricole SA and Societe Generale SA had their ratings cut one notch by Moody’s on 14 Sep, while BNP Paribas SA had its Aa2 long-term rating kept on review for downgrade.

- **Plan C: Eurozone policymakers, namely Germany, tackle the sovereign solvency and contagion issues whole-heartedly and holistically.** This would require fundamental changes to the current stance towards the EFSF expansion, Eurobonds proposal, and a Eurozone TARP-equivalent to take over the bad assets (mainly the PIIGS government debt) sitting on European banks’ books. If this materialises, and the probability looks small at this juncture given the mixed signals by different policymakers, this could spell relief of a more lasting nature.

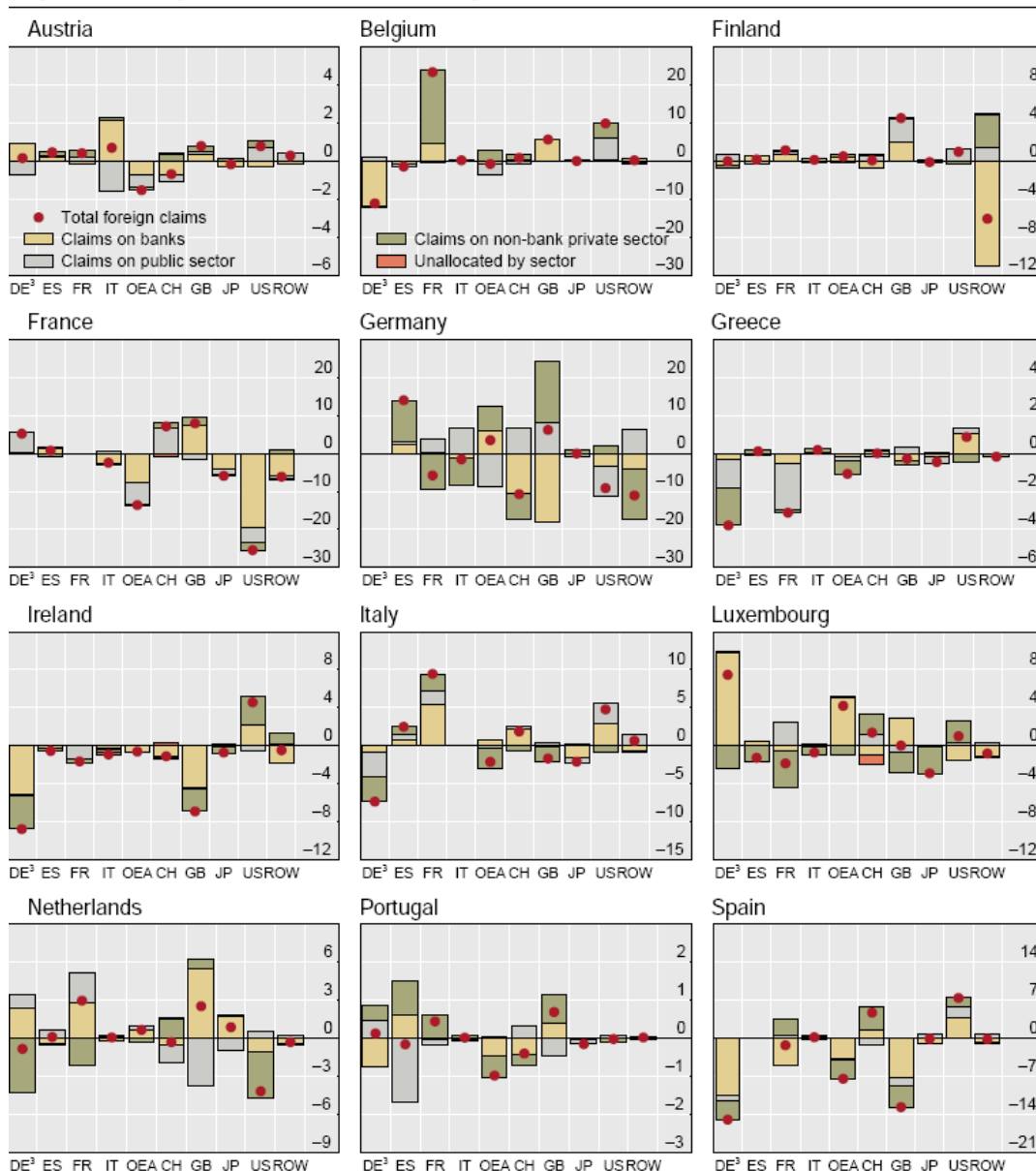
At this juncture, we remain cautious about the European banking sector. To compare the European banking sector deterioration with the US experience post-Lehman, we overlaid the current Stoxx 600 banking sub-index with the SPX500 Financial sub-index in the pre/post-Lehman period. T = 6 months before Lehman collapsed in the US & Feb 2011 when PIIGS fears resurfaced.

Assuming that the situation could potentially play out in a similar fashion (so far, the drying up of USD funding, holdings of peripheral European government bonds could sink further etc), the Stoxx 600 banking sub-index could fall further to reach a Lehman trough, assuming that a systemic banking crisis is a real risk for the Eurozone. Hence, it is still too early to conclude that European banks are “cheap” on a forward PE valuation. The fact that some of these banks’ CDS are already at 3-year highs are reflective of the risk-reward ratio at this juncture. See charts 7 & 8.

Chart 1: Foreign claims on Eurozone including PIGS countries

Estimated changes in foreign claims¹ on selected countries, Q1 2011

By bank nationality at constant end-Q1 2011 exchange rates,² in billions of US dollars



CH = Switzerland; DE = Germany; ES = Spain; FR = France; GB = United Kingdom; IT = Italy; JP = Japan; OEA = other euro area; ROW = rest of the world; US = United States.

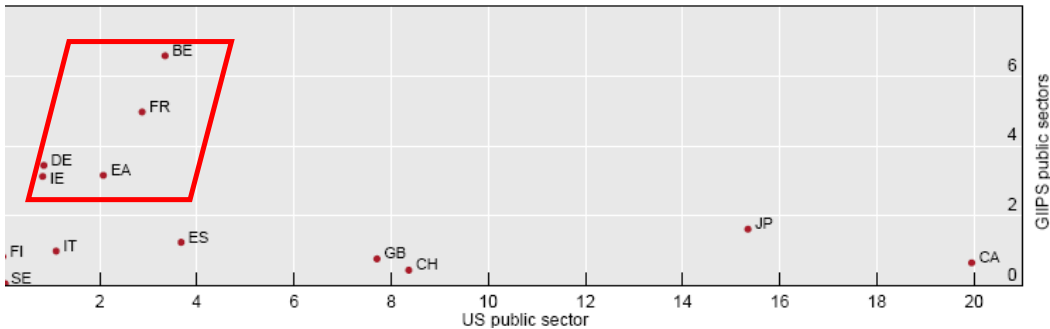
¹ Foreign claims consist of cross-border claims and local claims of foreign affiliates. Claims of banks headquartered in the respective country are not included, as these are not foreign claims. ² All claims are assumed to be denominated in euros. ³ Claims of German banks are on an immediate borrower basis, except claims on the Greek public sector, which are on an ultimate risk basis.

Source: BIS

Chart 2: exposure to PIGS public sector

Consolidated foreign claims on the public sectors of the GIIPS¹ countries and the US
By bank nationality, as a percentage of banks' total foreign claims

As at Q1 2011



BE = Belgium; CA = Canada; CH = Switzerland; DE = Germany; EA = euro area; ES = Spain; FI = Finland; FR = France; GB = United Kingdom; IE = Ireland; IT = Italy; JP = Japan; SE = Sweden; US = United States.

¹ GIIPS = Greece, Ireland, Italy, Portugal, Spain. Claims of banks headquartered in Ireland, Italy and Spain on their respective home country's public sector are not included, as these are not foreign claims.

Source: BIS

Chart 3: USD funding access drying up

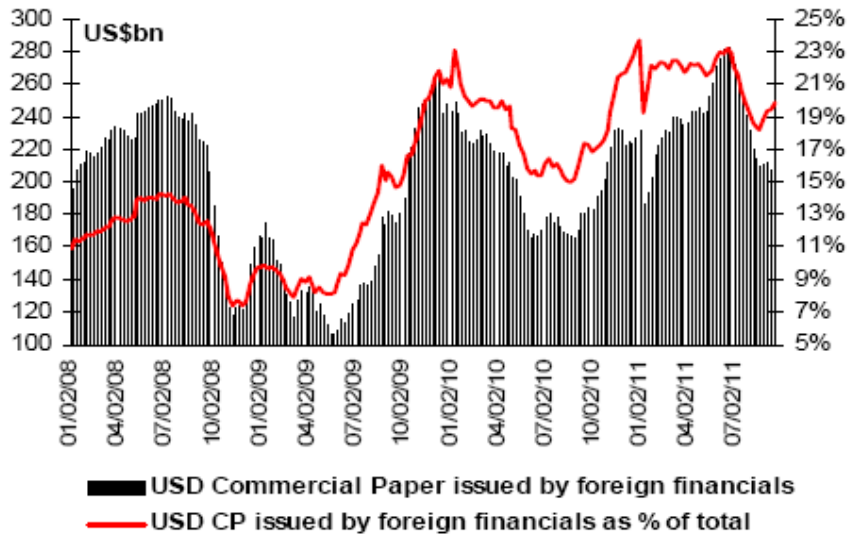


Chart 4: EUR LIBOR-OIS spread rising

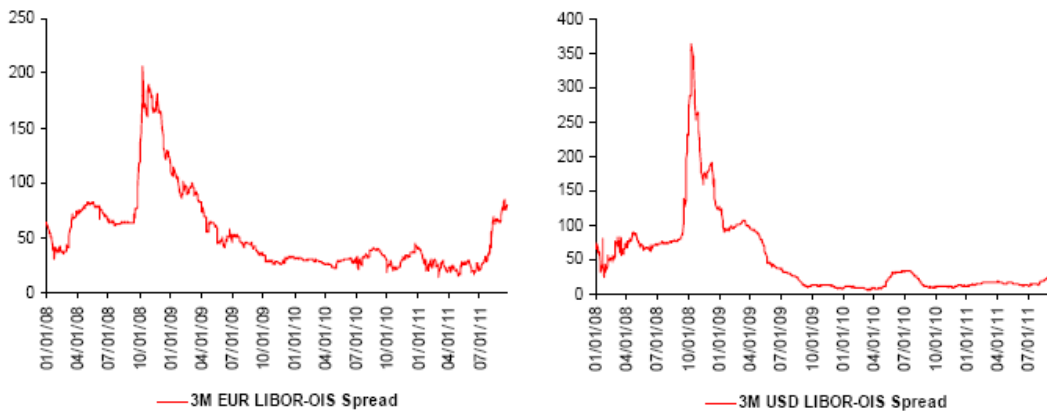


Chart 5: European banks placing excess liquidity with the ECB

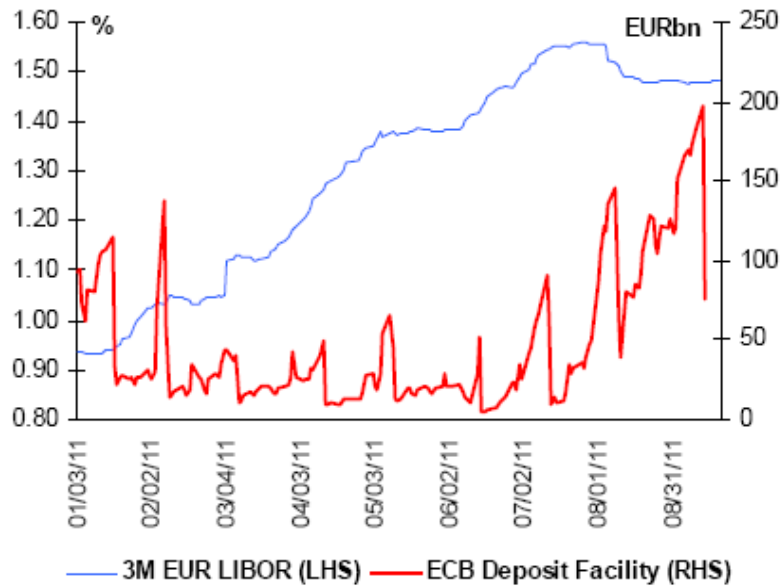
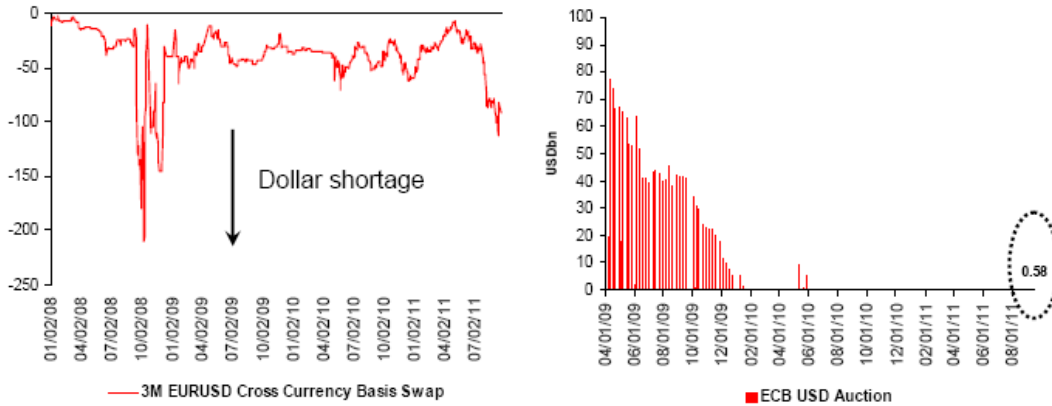


Chart 6: USD funding through the cross currency swap and ECB



**Chart 7: overlaying the current European banking crisis with the post-Lehman US experience
Stoxx 600 and S&P Subindex**



Source: Bloomberg, OCBC

Chart 8: Greek sovereign risk for selected German banks and insurers based on company filings, some of which include bond holdings as well as the value of loans.

FMS Wertmanagement	8.76 billion *
Commerzbank	2.2 billion
EAA	1.21 billion *
Deutsche Bank	1.15 billion
Munich Re	811 million
DZ Bank	793 million
Allianz	782 million
WGZ Bank	533 million
KfW Group	250 million
LB Berlin	230 million *
NordLB	217 million
LBBW	131 million
HSH Nordbank	108 million
BayernLB	101 million
Dekabank	100 million *
Helaba	86 million *
Hannover Re	Zero
Hypo Real Estate	Zero
TOTAL	17.46 billion

Figures are in euros at June 30, 2011

* Nominal figure

Source: Bloomberg

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