

# Weekly Credit Update

## Summary

- CDS indices are wider following Dubai debt fears
- High activity in the primary market
- S&P published its new capital ratio

## Headlines from the credit market this week

Despite Thanksgiving in the US it has been an eventful week in the credit market. The debt fears in Dubai (see below) were the main trigger for the widening. Currently, iTraxx Europe and Crossover trade at 93bp and 562bp respectively. In the cash market the reaction was primarily seen in the Tier 1 market where bids largely disappeared. We think that credit markets – financials in particular – are likely to remain nervous in the weeks ahead until the full extent of the problems in the Middle East is known.

During the week we saw good activity in the primary market. In addition it seems that there are more deals in the pipeline for the upcoming weeks and thus December may turn out to be busier than usual.

Table 1. Selected new issues during the week

Name	Rating	Coupon	Maturity	Currency	Size	Bond spread on issue date, (bp)*
Lottomatica	Baa3/BBB-	Fixed	7Y	EUR	0.75bn	Gov +235
Vivendi	NR/NR	Fixed	7 & 10Y	EUR	1.2bn	Gov +152-171
Volkswagen	A3/A-	Fixed	5Y	EUR	1.25bn	80
Hera	A2/A-	Fixed	10Y	EUR	0.5bn	115
Anglo American	Baa1/BBB	Fixed	7Y	EUR	0.75bn	Gov +174

Note: Ratings are Moody's and S&P. \* Mid-Swaps for Fixed, Discount Margin for floating

Source: Danske Markets & Bloomberg

## Dubai World asks for debt standstill

The news that Dubai World is seeking a debt standstill rattled bond investors (as well as financial markets in general) on Thursday. Dubai World is an entity owned by the Government of Dubai and is the holding company responsible for developing real estate in Dubai. One of its subsidiaries, Nakheel, has USD3.5bn maturing next month and it is for this particular bond Dubai World has requested a standstill until May 2010. At this stage it is still uncertain whether this will be deemed a credit event and thereby trigger settlement of outstanding CDS contracts.

Dubai has been through a property market boom, which was ended by the credit crisis and the debt standstill highlights the problems Dubai is facing. From a credit perspective the most interesting aspect is the potential risk of a spill-over to banks – or other companies – exposed to Dubai. Initially, (sub) CDS prices of a number of British banks widened (more than the market) on the back of the Dubai news.

### iTraxx Europe (5Y CDS)



Source: Markit

### iTraxx Crossover (5Y CDS)



Source: Markit

### VIX volatility index



Source: Ecowin Pro

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Although some UK banks have exposure to UAE (Dubai is only one of seven emirates) it is not material in our view. Below we list the largest exposures to UAE of Western banks.

<b>Western banks' exposure to UAE by end 2008 (USD bn)</b>			
	<b>Exposure</b>	<b>Total loans</b>	<b>% of total loans</b>
HSBC	17.0	932	1.8%
Standard Chartered	7.7	174	4.4%
ABN (RBS)	2.2	1275	0.2%
Barclays	3.6	673	0.5%
Citibank	1.9	709	0.3%
BNP Paribas	1.7	509	0.3%
Lloyds	1.6	354	0.5%

*Source: Danske Markets, Bloomberg & Emirates Banks Association*

As can be seen the exposure to the region is fairly limited. Furthermore, it should be stressed that so far we are only talking about one (big) company. Still, it is a factor to watch out for in case the problems are more widespread than they appear. Remember, back in 2007 virtually everybody agreed that subprime mortgage loans were a manageable and limited problem. So some caution is warranted.

#### **S&P presents new capital ratio (Risk Adjusted Capital – RAC)**

In the beginning of the week, S&P presented its much awaited RAC (Risk Adjusted Capital) ratio. The aim of the RAC is to develop a ratio which bridges the gap between a simple leverage ratio and the opaque Basel II (in particular for IRB banks) Tier 1 ratio. The RAC is based solely on publicly available information and is globally comparable. The RAC will be used by S&P as a supplement to the existing rating process and will form the starting point of the analysis of bank capital.

Of the 45 global banks that S&P has investigated so far only six have RACs above 8%, which is the threshold S&P sees as separating capital from being a negative rating factor. This underlines that capital remains a key issue for banks worldwide and that we are by no means out of the woods yet. Loan losses are likely to stay at elevated levels for some time and continue to put pressure on capital ratios.

For a number of banks (see table on next page) there is a considerable dispersion between the RAC and the reported Tier 1 ratio. The prime example is UBS, which has a Tier 1 of 13.2% but a RAC of only 2.2%. The prime reason for the big difference is S&P's clear preference for equity capital and reserves over hybrid core capital. For banks with mandatory convertible hybrid capital the RAC and the Tier 1 ratio should therefore align over time and some caution is therefore warranted when looking at the RAC. In addition to this, S&P applies a substantially higher risk weight to the trading book –even when including the expected increase in risk weight of the trading book that was agreed by the G20.

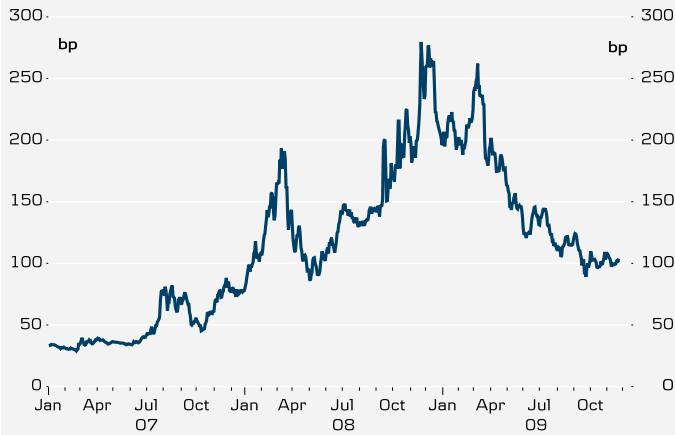
It should be highlighted that no regard is directed to differences in loan underwriting standards. Hence, S&P only takes a stance on the risk weight of the sector exposure and not the variance in credit quality among the clients within the same sector. In our view this punishes the more conservative banks that have stricter underwriting standards. Hence for banks with large capital reliefs following the (full) implementation of Basel II significant dispersion can be anticipated between the Tier 1 and the RAC. In other words, banks with low (internally assessed) risk weights of their assets will have a relatively low RAC compared to their Tier 1 ratio.

## Comparison of banks' RAC, Basel II Tier 1, and leverage ratios

	RAC ratio	Basel II Tier 1 ratio	Leverage ratio*	As of
<b>Quintile 1</b>				
ING Bank N.V.	8.9	9.3	3.1	12/31/2008
Dexia S.A.	8.4	10.6	2.4	12/31/2008
Groupe Credit Mutuel	8.4	9.9	3.4	12/31/2008
Goldman Sachs Group Inc.	8.3	13.8	6.8	06/30/2009
Morgan Stanley	8.1	15.8	6.4	06/30/2009
Toronto-Dominion Bank	8.0	10.9	3.3	04/30/2009
Bank of Nova Scotia	7.9	10.4	4.5	07/31/2009
HSBC Holdings PLC	7.9	8.3	3.6	12/31/2008
Rabobank Nederland	7.9	12.7	4.6	12/31/2008
<b>Quintile 2</b>				
Standard Chartered Bank	7.7	9.9	4.1	12/31/2008
Bank of Montreal	7.3	10.7	4.3	04/30/2009
Nordea Bank AB	7.3	7.4	3.2	12/31/2008
DBS Bank Ltd.	7.3	10.1	7.4	12/31/2008
KBC Bank	7.2	9.7	3.5	12/31/2008
Royal Bank of Canada	7.1	8.9	3.8	04/30/2009
JPMorgan Chase & Co.	7.0	9.7	5.9	06/30/2009
National Australia Bank Ltd.	6.9	8.3	4.5	03/31/2009
Credit Suisse Group AG	6.9	15.5	2.5	06/30/2009
<b>Quintile 3</b>				
DnB NOR Group	6.9	6.3	4.4	12/31/2008
Societe Generale	6.6	8.4	2.7	12/31/2008
Bank of New York Mellon Corp.	6.5	12.5	6.7	06/30/2009
Banco Santander S.A.	6.5	8.7	3.7	12/31/2008
Wells Fargo & Co.	6.4	9.8	5.9	06/30/2009
Commonwealth Bank of Australia	6.3	8.1	3.3	06/30/2009
BNP Paribas	6.3	7.8	1.9	12/31/2008
Credit Agricole S.A.	6.2	8.8	2.6	12/31/2008
Intesa Sanpaolo SpA	6.1	7.1	4.1	12/31/2008
<b>Quintile 4</b>				
Australia and New Zealand Banking Group	6.1	8.2	4.8	03/31/2009
Caja de Ahorros y Pensiones de Barcelona	6.0	10.1	5.7	12/31/2008
Bank of America Corp.	5.8	11.9	5.2	06/30/2009
Barclays Bank PLC	5.6	8.8	1.6	12/31/2008
UniCredit SpA	5.4	6.7	3.2	12/31/2008
Danske Bank A/S	5.4	12.2	2.6	06/30/2009
Deutsche Bank AG	5.3	10.1	1.2	12/31/2008
Allied Irish Banks PLC	5.2	7.4	4.7	12/31/2008
Banco Bilbao Vizcaya Argentaria, S.A.	5.1	7.6	4.4	12/31/2008
<b>Quintile 5</b>				
Bank of Ireland	4.8	12.0	2.6	03/31/2009
Bayerische Landesbank*	4.4	8.0	2.7	12/31/2008
Mitsubishi UFJ Financial Group, Inc.	4.1	7.8	3.3	03/31/2009
DZ BANK AG	3.8	7.4	2.0	12/31/2008
Landesbank Baden-Wuerttemberg	3.7	6.9	2.1	12/31/2008
Sumitomo Mitsui Financial Group Inc.	2.5	8.2	2.5	03/31/2009
UBS AG	2.2	13.2	0.5	06/30/2009
Citigroup Inc.	2.1	12.7	0.6	06/30/2009
Mizuho Financial Group Inc.	N/A	6.4	1.7	03/31/2009
Global Average	6.1	9.7	3.6	

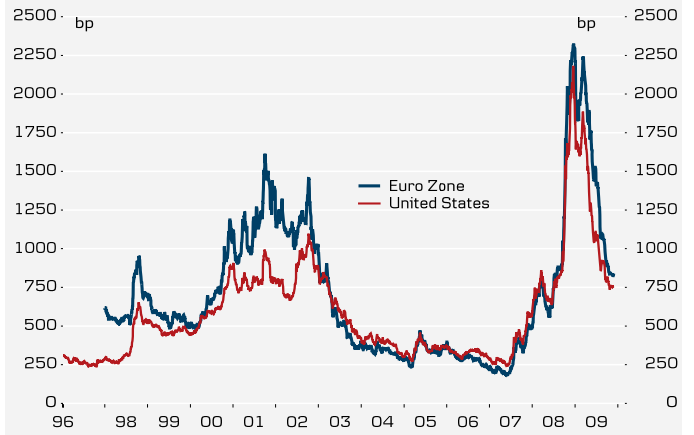
\*Leverage ratio: The capital of the bank to total assets. Source: S&P's

US investment grade CDS index (CDX)



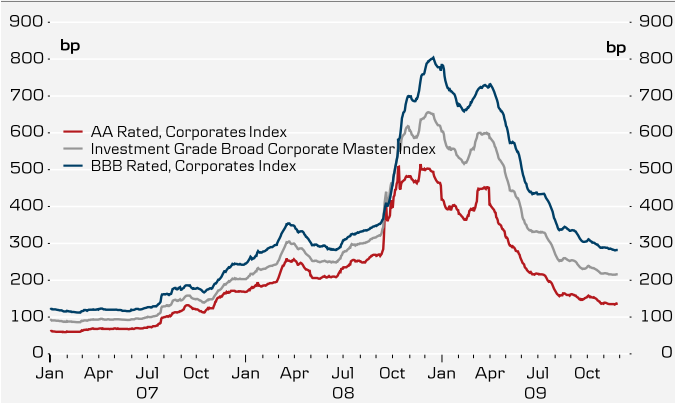
Source: Ecowin Pro

Merrill Lynch US & European high yield cash indices



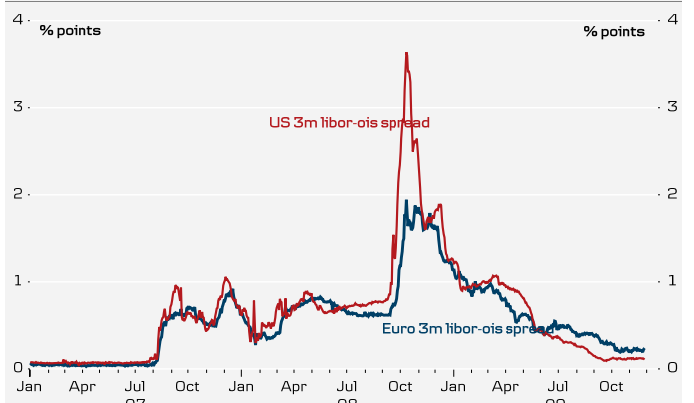
Source: Ecowin Pro

US cash indices



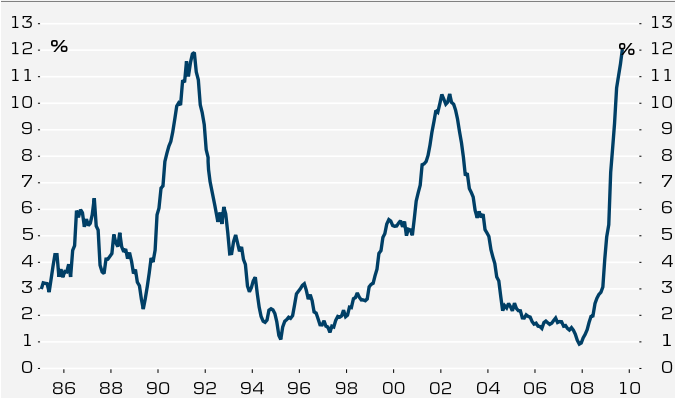
Source: Ecowin Pro

3M LIBOR-OIS spread



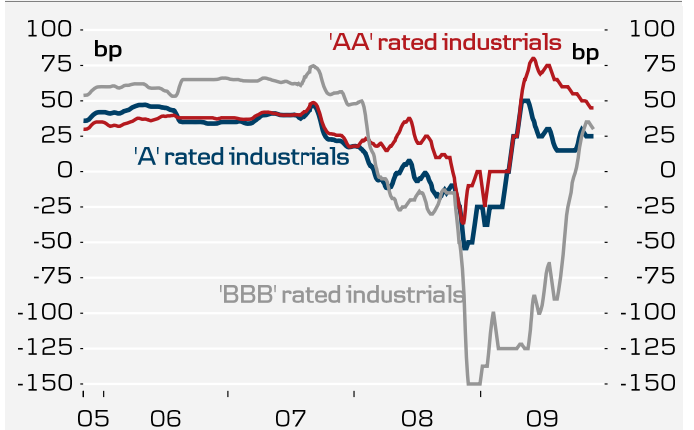
Source: Ecowin Pro

Moody's global speculative default rate (LTM)



Source: Ecowin Pro

Slope of US credit curves (2Y spread - 10Y spread)



Source: Ecowin Pro

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