Weekly Credit Outlook

31 OCTOBER 2011

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Last week we published reports on China property, US automakers, Indonesian coal mining, US retailers, the Asian oil industry, US utilities, asset managers, money market fund managers, Russian banks, Bahraini banks, Paraguay, Russian RMBS, and US credit card ABS, among other reports.

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European Sovereign & Banking Crisis

Key Credit Implications of Euro Area Summit

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Last Thursday, European policymakers issued a communiqué announcing a series of additional measures aimed at addressing the formidable challenges facing the euro area. The following are the key credit takeaways we draw from the statement:

- **Aaa-rated euro area countries: neutral to negative.** These countries face increased exposure from European Financial Stability Facility (EFSF) first-loss guarantees potentially being called. Also, the prospect of additional mutual support implies a greater risk to creditors of the countries that ultimately provide support. However, if the measures are successful, they could more than offset this additional risk by improving overall credit conditions
- **Greece: negative for current creditors, positive for future debt sustainability.** Private holders of Greek sovereign bonds now face a default in the form of debt write-downs of 50%, although they may benefit in the future from improved sovereign debt sustainability. It is still uncertain whether creditors will face additional write-downs in the event of a re-default
- **Ireland and Portugal: neutral.** Overall, creditors of countries currently receiving support and other countries that may suffer from limited market access in the future benefit from the increased resources that the EFSF will have available. However, while the announcement restates the 21 July language on the private-sector involvement (PSI) solution for Greece as being unique, it also re-emphasizes the conditionality of existing support programmes
- **Italy and Spain: neutral.** It is not clear if the enhanced tools proposed for the EFSF will be effective at easing the market-funding challenges facing the two countries. The country-specific measures previously announced for both are positive, but considerable risks remain in successfully implementing the fiscal and structural reform programs
- **European banks: marginally positive.** Capital strengthening and funding guarantees benefit creditors and may help improve market conditions, at least temporarily. However, they will not, in our view, solve the underlying problem of sovereign debt concerns
- **European insurers: neutral to mildly positive.** The increased Greek debt write-down does not materially affect insurers.[1] To the extent that the European Union's (EU) decisions help stabilize the credit quality of sovereigns and banks, insurers benefit
- **European Financial Stability Facility: neutral.** Neither of the two options for expansion/leverage of the EFSF involves a change in the way that member states guarantee notes issued by EFSF and, therefore, neither affects the EFSF's creditworthiness

In the rest of this report, we assess the three key announcements from the euro area summit: EFSF expansion options, bank recapitalization and funding initiatives and amended Greek PSI.

EFSF expansion options. The announced amendments establish a first-loss insurance scheme for new debt and provide for EFSF seed funding for special purpose investment vehicles. Supported by third parties such as sovereign wealth funds and private investors, these vehicles would enlarge the amount of resources available to extend loans for bank recapitalization and for buying bonds in the primary and secondary markets. The facility's lending capacity, after deducting current commitments, is €250

[1] See European Insurers: EU Sovereign Pressures Have Limited Impact on Credit Profiles So Far, 20 October 2011.

billion. Allowing for leverage of 4x-5x would expand the lending capacity to at least €1 trillion. More importantly, the first-loss scheme would place public sector providers of support in a first-loss position and as such creates incentives for protection of all investor classes.

It is our understanding that neither of these options involves any change in the way notes issued by EFSF are guaranteed by member states and, therefore, the options alone will not affect our assessment of the EFSF's creditworthiness. Meanwhile, the announced commitment of sizable additional funding via the leverage of the EFSF is positive for sovereigns currently receiving support (and those potentially receiving support in future). Leveraging the resources of the EFSF means that these stressed credits will not need to access markets for financing for an extended period.

However, overall the package continues to reflect the tension between the increasing recognition among euro area leaders that the strong need to increase their level of support for the weak, and the significant opposition within the strong nations to doing so. For example, the size of the "leveraged" EFSF is sufficient to keep programme nations out of the market for an extended period and provide short-term support to other sovereigns facing limited market access. However, the amount would be insufficient should a larger member of the euro area face extended market access or solvency issues.

It also falls well short of the amount needed to mutualise risk across the euro area. In that sense, the package merely represents another reactive crisis management measure, effectively "buying time" while policymakers rely on the medium-term competitiveness measures to foster growth. There remain significant risks to this strategy. Amid bleak growth prospects and implementation challenges, movement toward increased levels of mutual support and integration is unavoidable if the currency union is to address the fundamental issues that generated the current crisis.

The announcement discusses at a high level a variety of initiatives to support closer coordination among euro area (and EU) sovereigns. As such, it moves somewhat in the direction of the central coordination and mutualisation of resource and risk, though it included no specific measures to move towards closer fiscal integration. In the absence of such measures, the euro area authorities are continuing to rely on rapid growth and structural changes for easing concerns over the ability of governments to refinance their debt while they also shield the weaker sovereigns from the markets. This leaves the euro area sovereign debt markets prone to disruption.

Bank recapitalization and funding initiatives. The announcements from EU leaders and the European Banking Authority on funding guarantees and bank recapitalisations are significant steps that can help to underpin banks' credit quality, and, as such, they are marginally credit positive for European banks. As our above comments on the Euro Summit announcements show, we believe that these announcements only partly address the sovereign challenges and sovereign debt concerns in the euro area. And it is this European sovereign debt crisis that remains the underlying problem plaguing the risk perception and market funding environment for European banks. As a result, the ultimate solution for this underlying problem is unlikely to reside in sovereign guarantees or sovereign-funded recapitalisation of banks.[2] Funding guarantees and recapitalisations can help stabilise banks for some time, but the banks' underlying vulnerability to the European sovereign debt crisis remains.

We see the announcements as having the following positive aspects for bank creditors:

» **Funding guarantees.** While details remain unclear, EU governments have clearly stated their determination to help banks that face acute funding pressures. At this stage, the banking crisis is first

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[2] See Further European Bank Recapitalizations Would Be Credit Positive, but Unlikely to Bring Sustained Improvement in Sentiment, 10 October 2011 and Accelerating Discussions to Recapitalize European Banks Are Credit Positive, 17 October 2011.

and foremost a funding crisis, driven by investor risk aversion that reflects high uncertainty over the quality of banks' sovereign and country exposures. The likelihood that banks facing funding pressure will receive assistance of some sort is positive for creditors, augmenting existing support, including from the European Central Bank. If implemented quickly and clearly, the availability of funding guarantees, combined with capital strengthening, are likely to improve funding conditions, at least so long as sovereign guarantors are perceived to be creditworthy

» **More capital.** Even though the amounts of capital being contemplated cannot guard against the risk of a default of either a number of small or even one large euro area sovereign (and it is questionable whether buffers large enough to achieve that objective would leave banks with viable business models), more capital enhances banks' ability to cope with weakening economic and asset quality trends. Greek banks, in particular, will receive needed capital to offset sovereign-related losses

The following features have negative implications for bank and sovereign creditors:

» **Sovereign problems remain.** While these measures may alleviate investor concerns temporarily, the provision of guarantees and capital by euro area sovereigns will not alleviate long-term pressures and return markets to anything approaching normalcy as long as the underlying concerns over sovereign credit risk remain

» **Risks on path to higher capital.** We see heightened implementation risk to the announced capital strengthening targets that the EU is mandating that banks reach by 30 June 2012. Those risks include the following:

- Some banks will struggle to raise capital in private markets or via lower dividends, reduced bonus payments and other cost cutting measures. The capacity of such banks to bolster capital through balance sheet restructuring and debt-to-equity conversions will also likely be limited. As such, we expect that at least a portion of the additional capital required will come from governments. This would further pressure already-stretched sovereign balance sheets or dilute mutual resources such as the EFSF, unless any provided capital is repaid fully and timely, which is uncertain ex ante

- It is likely that banks will try to reduce their lending to shrink their asset base in order to meet at least part of their capital targets. Any such deleveraging risks damaging economic growth, which would exacerbate banks' asset quality challenges, and, in turn, would press banks to deleverage even more, possibly creating a vicious cycle

» **Greek losses are unclear.** Greek private-sector creditors will lose at least 50% of their investment. They may still lose more

» **Elevated risk for junior creditors.** Restructuring and debt-to-equity swaps may significantly increase risk for junior bondholders

» **Hedge ineffectiveness of sovereign credit default swaps.** The push towards a "voluntary" restructuring of Greek government debt looks set to result in the avoidance of a credit event as defined by the International Swaps and Derivatives Association. The likely perspective of bondholders facing a 50% haircut on their sovereign exposure without the credit protection becoming effective will raise questions about the hedge effectiveness of credit default swaps for sovereign debt and thus increase banks' net exposure to European sovereigns

Amended Greek private-sector involvement (PSI). Policymakers agreed on a revised funding programme for Greece, including a default in the form of a structured ("voluntary") contribution (PSI)

by the financial sector of 50%.[3] The public sector also agreed to increase its programme funding, and has agreed to strengthen the institutional structures responsible for monitoring the implementation of the Greek programme. This is likely to mitigate some of the implementation problems that have been a major contributor to the deterioration of Greek public finances and in Greece's macroeconomic performance. Some of the increased funding will go to recapitalise the Greek banking sector, which we expect will increase confidence in the future solvency of these institutions.

While the deeper PSI relieves some pressure on the Greek sovereign, it is not a complete solution to Greece's solvency problems. The debt burden will still remain very substantial after a successful execution of the PSI package: by officials' own estimates, the Greek debt stock will still be around 120% of GDP in 2020. Even this debt level may be challenging to achieve in this time scale given the formidable challenges facing Greece, most notably increasing the potential growth rate, implementing large-scale structural economic and fiscal reforms, and encouraging investors to purchase state-owned assets in the country's ambitious privatisation programme. Given the difficult tasks that still lie ahead for the Greek authorities, we cannot exclude the possibility of a further haircut for bondholders.

More broadly, while the statement restates the assertion that Greece's position is unique, it also reiterates the conditional nature of other support programmes provided to date. If EU policymakers once again become concerned about the actual or prospective level of public sector ownership of a euro area government's debt stock and about the risk of subsequent credit losses, pressure would likely resurface for private sector participation in subsequent rounds of official financing given the Greece precedent now being set.

We expect future private sector participation to follow the term sheet for the European Stability Mechanism (ESM),[4] which envisions private-sector involvement for those countries that need to access liquidity support from the EFSF or the ESM but are found to be insolvent (based on a debt sustainability analysis conducted by the European Commission and the International Monetary Fund in conjunction with the European Central Bank). We expect euro area government bonds issued from July 2013 onwards to include standardised collective action clauses to facilitate such a restructuring. The precedent that is being set with Greek PSI represents a structural break in the funding costs for stressed or potentially stressed euro area countries, and probably also raises the hurdles that current programme countries will face in accessing markets again.

The PSI announcement also generates a potentially important unintended consequence. Statements by International Swaps and Derivatives Association officials indicate that the Greek "voluntary exchange" will not trigger credit default swaps (CDS). While it is too early to tell, this may reduce demand for debt of stressed or potentially stressed euro area countries, as the effectiveness of CDS as a hedge for sovereign debt exposures has been undermined.

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[3] See EU Support Package Permits Orderly Default by Greece and Buys Time, But Credit Effects Are Mixed for Other Euro Area Sovereigns, 25 July 2011. As with the PSI exchanges proposed in July, execution of the exchanges proposed last Thursday would constitute a distressed exchange, and therefore a default, under our definition.

[4] See EU Support Package Permits Orderly Default by Greece and Buys Time, But Credit Effects Are Mixed for Other Euro Area Sovereigns, 25 July 2011.

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Bank Recapitalisation Plan, While Credit Positive, Is Not Likely to Resolve Sovereign Exposure Concerns

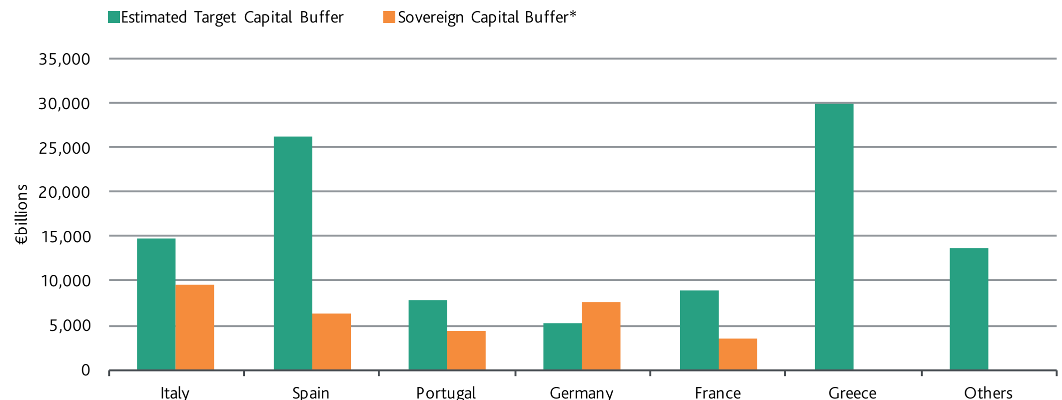
Last Wednesday, the European Banking Authority (EBA) published plans to force systemically important European banks to strengthen their capital by 30 June 2012, while on Thursday European Union (EU) heads of state or government stressed their support for bank recapitalisation.[5] The EBA's capital targets, while credit positive, will not resolve the sovereign debt concerns affecting EU banks. The underlying problem affecting many European banks is uncertainty about the ability of all but the strongest euro area sovereigns to continue financing their debt burdens, as reflected in disrupted capital and interbank markets. Recapitalisation of the banking sector, at least with the capital amounts contemplated, will not solve the problem. The additional capital required in the EBA's proposals would not be sufficient to guard against multiple sovereign defaults or against further market value declines in government securities if investor concerns about sovereign risks rise.[6]

Furthermore, the EBA's plan will be most credit positive if bank recapitalisation occurs via internal or external capital generation, and not by shrinking assets and deleveraging. While the strongest banks may be able to access private capital, this option will not be possible for many banks. Substantial bank deleveraging, however, would reduce the supply of credit to already weakened European economies. Unless offset by external support, this could amplify, rather than alleviate, bank asset quality challenges.

EBA asks banks to reach 9% core Tier 1 ratios and hold temporary buffers. The EBA is requiring banks to reach a 9% core Tier 1 ratio by the end of June 2012 (based on Basel 2.5-compliant risk weighting of assets) and build temporary buffers of an EBA-estimated €40 billion against sovereign risks. The EBA estimates that 70 European banks covered by its recapitalisation plan need to strengthen their capital by about €106 billion. The EBA's capital targets are not derived from sovereign stress testing, but are designed to allow banks to withstand a range of shocks. The EBA anticipates the greatest capital needs in Greece, Italy and Spain, while the amount for Portuguese banks is also large relative to the size of its economy (Exhibit 1).

EXHIBIT 1

EBA-Estimated Target and Sovereign Capital Buffers in Selected Countries



*The sovereign capital buffer is indicative and can be covered by existing core Tier 1 capital for banks whose core Tier 1 ratio exceeds 9%.

Source: EBA

[5] We commented on the EBA's and European governments' other announcement here Euro Area Summit – Summary of Key Credit Implications, 28 October 2011.

[6] See Further European Bank Recapitalizations Would Be Credit Positive but Unlikely to Bring Sustained Improvement in Sentiment, 10 October 2011.

Rated European banks are vulnerable to sovereign concerns owing to their large exposures. EU banks remain highly exposed to sovereign and related country risks. Our recent survey of 252 rated European banks[7] suggest combined sovereign and country exposures (net of loss provisions, but excluding credit default swaps) of approximately €80 billion to Greece (Ca developing),[8] €50 billion to Ireland (Ba1 negative), €34 billion to Portugal (Ba2 negative), €275 billion to Italy (A2 negative), €176 billion to Spain (A1 negative), and €98 billion to Belgium (Aa1 review for downgrade).

The sheer size of these exposures and their broad distribution across European banks illustrates the difficulty of gauging the possible extent of losses arising from sovereign defaults or the economic distress that would accompany them. Importantly, the sovereign ratings reflect our view that defaults for all these sovereigns except Greece remain highly unlikely.

The large exposures also illustrate the inadequacy of the capital targets announced last Wednesday against anything other than contained defaults of small countries. Hypothetical scenarios assessing the impact of sequential country defaults (with a loss assumption of 50%, which may be too low) suggest that while many European banks could absorb a default by Greece, Portugal and Ireland, adding Italy, Spain, or both increases the capital shortfall to very high levels (see Exhibits 2 and 3, first five scenarios). Our hypothetical scenarios use a 9% core Tier 1 ratio (on a Basel II basis) as the benchmark for each bank and only consider directly-held government debt. They do not incorporate European banks' much larger and harder to quantify indirect exposure to sovereigns, including interbank and private-sector exposures.

We have also assessed an additional sovereign scenario (Exhibits 2 and 3, scenario 6) based on stress assumptions derived from current market prices for sovereign securities and hypothetical rating changes. This scenario suggests that total capital of approximately €124 billion is needed to ensure that each of our 252 rated banks reaches a minimum 9% core Tier 1 capital ratio after applying our stresses. We note, however, that this scenario also only considers directly-held government debt, not banks' much larger and harder to quantify indirect exposure to sovereigns, including interbank and private-sector exposures.

EXHIBIT 2

Theoretical Government Debt Loss Scenarios

	Scenario 1	Scenario 2	Scenario 3	Scenario 4	Scenario 5	Scenario 6
Greece	50%	50%	50%	50%	50%	75%
Portugal		50%	50%	50%	50%	50%
Ireland			50%	50%	50%	37%
Italy				50%	50%	10%
Spain					50%	10%
Belgium						2%

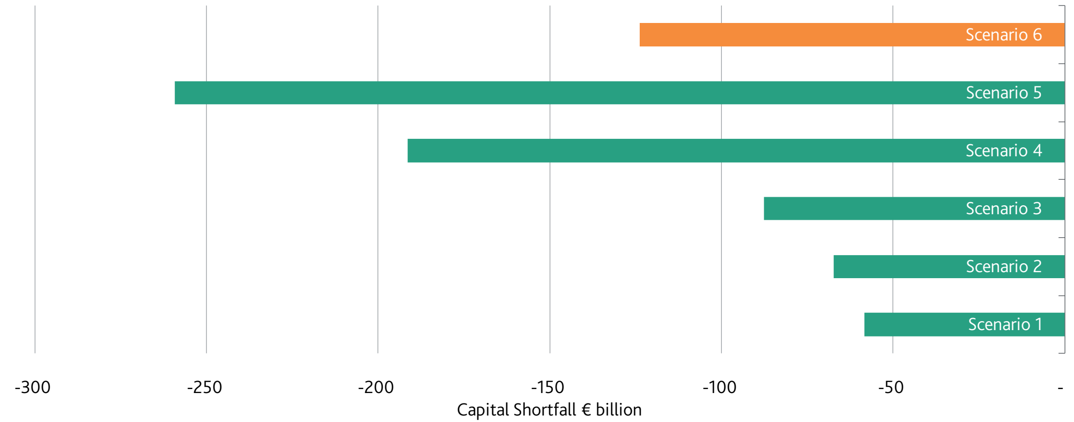
Source: Moody's

[7] Our survey data may not represent the most recent information for each bank.
[8] Ratings shown are the long-term government bond rating and corresponding outlook/review status.

EXHIBIT 3
Capital Shortfalls in Government Debt Loss Scenarios (Rated Banks in Each Banking System)

	Scenario Capital Shortfall € Million						Scenario Capital Shortfall As Percent 2011 GDP					
Banking System	Scenario 1	Scenario 2	Scenario 3	Scenario 4	Scenario 5	Scenario 6	Scenario 1	Scenario 2	Scenario 3	Scenario 4	Scenario 5	Scenario 6
Austria	-440	-450	-450	-647	-685	-529	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%
Baltics	-3	-3	-3	-3	-3	-3	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Belgium & Luxembourg	-	-	-	-7,422	-9,333	-988	0.0%	0.0%	0.0%	1.8%	2.3%	0.2%
Bulgaria	-	-	-	-	-	-	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Cyprus	-2,454	-2,454	-2,630	-2,690	-2,715	-3,965	14.0%	14.0%	14.9%	15.3%	15.4%	22.5%
Czech Republic	-40	-40	-40	-40	-40	-40	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Denmark/Faroer	-323	-323	-323	-323	-323	-323	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%
Finland	-36	-36	-36	36	-36	-36	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
France	-3,840	-4,119	-4,534	-24,742	-28,975	-10,855	0.2%	0.2%	0.2%	1.2%	1.5%	0.5%
Germany	-3,135	-3,690	-3,916	-13,527	-19,629	-7, 218	0.1%	0.1%	0.2%	0.5%	0.8%	0.3%
Greece	-19,074	-19,074	-19,086	-19,163	-19,163	-29,592	8.6%	8.6%	8.6%	8.7%	8.7%	13.4%
Hungary	-	-	-	-	-	-	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Ireland	-5,164	-5,287	-24,402	-24,778	-24,963	-19,346	3.4%	3.4%	15.8%	16.1%	16.2%	12.6%
Italy	-18,056	-18,216	-18,357	-82,485	-83,301	-31,705	1.2%	1.2%	1.2%	5.3%	5.3%	2.0%
Netherlands	-321	-321	-391	-696	-1,089	-462	0.1%	0.1%	0.1%	0.1%	0.2%	0.1%
Norway	-2	-2	-2	-2	-2	-2	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Poland	-	-	-	-	-	-	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Portugal	-612	-8,287	-8,571	-9,323	-10,259	-9,159	0.4%	5.0%	5.1%	5.6%	6.1%	5.5%
Romania	-	-	-	-	-	-	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Slovakia	-	-	-	-	-	-	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Slovenia	-271	-278	-286	-313	-333	-305	0.7%	0.8%	0.8%	0.9%	0.9%	0.8%
Spain	-4,517	-4,578	-4,578	-5,154	56,366	-9,194	0.4%	0.4%	0.4%	0.5%	5.4%	0.9%
Sweden	-	-	-	-	-	-	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Switzerland	-	-	-	-	-	-	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
United Kingdom	-31	-31	-32	-41	-1,956	-37	0.0%	0.0%	0.0%	0.0%	0.1%	0.0%
Total	-58,318	-67,189	-87,635	-191,385	-259,171	-123,758						

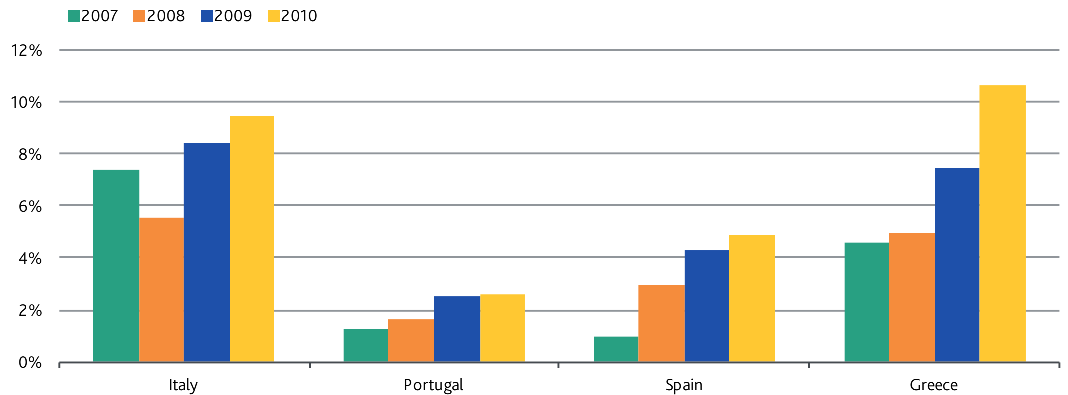
EXHIBIT 4
Comparison Of Six Government Debt Loss Scenarios (252 Rated European Banks)



Source: Moody's

Stronger capital will help banks cope with deteriorating asset quality. As stated, we believe capital strengthening is positive and warranted for many banks operating in stressed EU countries, including Greece, Portugal, Ireland, Italy, and Spain. These banks face rising problem loans, which reflect weakening economies (Exhibit 5). More capital will help banks withstand such adverse conditions.

EXHIBIT 5
Problem Loans % Gross Loans in Selected Countries



Note: Weighted average for rated banks per country, as of year-end.
Source: Moody's Banking FM

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Coordinated Funding Guarantees Would Be Credit Positive for European Banks, But Details Yet to Be Agreed

Last Thursday, the euro area heads of state or government acknowledged the need for EU-wide coordinated funding guarantees for banks and tasked various institutions to urgently draw up a proposal for such guarantees.[9] If successfully agreed and implemented, coordinated medium-term funding guarantees will be credit positive for banks. There remains considerable uncertainty, however, if, when and to what extent an EU-wide coordinated funding scheme will come, which weakens the positive credit implications for banks.

The euro area leaders tasked the European Commission on Thursday to urgently explore a "truly coordinated approach regarding entry criteria, pricing and conditions" for term funding guarantees. The Commission will collaborate with the European Banking Authority (EBA), the European Central Bank (ECB) and the European Investment Bank (EIB) and submit a report to the EU's Economic and Financial Committee, which also plays a key role in negotiations with investors about haircuts for Greek debt.

Last week's statement of euro area leaders re-confirms their systemic support for banks, a credit-positive for the latter. Term funding guarantees (whether provided at a national level or, more effective, coordinated across the EU) can help banks regain access to funding markets. And regaining such access is critical to address the current crisis in the euro area in our view. The market for term funding is currently all but closed in the EU, and while banks' funding needs for 2011 have been mostly addressed, many banks will likely continue to find it difficult to tap the capital markets in 2012.

In our view, the euro area leaders' public acknowledgment that (1) re-opening funding markets is crucial and (2) that EU-wide coordination is important make it more likely that coordination will ultimately occur. That said, the lack of detail in last week's announcement leaves a worrying degree of uncertainty. It should be remembered that during the 2008-09 global financial crisis, the EU states did not agree on a single framework for state guarantees, although the EU Commission set broad guidelines. This precedent bodes poorly for EU countries' ability to act swiftly and coordinated this time around.

Coordination has become much more important. In particular, for banks in countries under official sector support programmes (programme countries), an EU-wide coordinated guarantee scheme is much more likely to re-open access to currently closed term-funding markets than national guarantee programmes. Such national guarantee schemes have become ineffective in programme countries where the guarantors, the sovereigns, are themselves facing funding difficulties.

Europe's economy depends on banks regaining access to term funding, as they will otherwise become too reliant on short-term ECB funding or be pressured to deleverage and restrict lending, dragging down economic growth. Banks need long-term funds to limit duration mismatches between their assets and liabilities, even though short-term funding is available as needed for solvent banks from the European Central Bank (ECB) and national central banks.[10]

Importantly, the ECB continues to offer solvent euro area banks with eligible collateral unlimited amounts of funding with terms of up to 13 months, providing a stable source of short- and intermediate-term, but not long-term funding. On 26 October 2011, 181 banks took up the ECB's offer of one-year funds for a total of €56.9 billion. The ECB will offer 13-month funds to banks in December 2011.

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[9] See Annex 2 of Euro Summit Statement. We are commenting separately on several other aspects of this announcement, see Euro Area Summit – Summary of Key Credit Implications, 28 October 2011.
[10] See Central Bank Support For Euro Area Banks And Sovereigns Debt Markets, 17 October 2011.

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Hedgers of Greek and Other Sovereign Debt Lose in a Voluntary Restructuring

In the Euro Summit statement released last Thursday, euro area governments put significant pressure on private investors to participate in a voluntary exchange of Greek debt and take a 50% par haircut. But last Thursday, International Swaps and Derivatives Association (ISDA) General Counsel David Geen suggested that such a voluntary exchange would not constitute a credit event.[11] If so, European banks and others that have hedged their cash position in Greek debt by buying credit default swap (CDS) protection on Greece would not receive a compensating credit protection payment. The demonstrated ineffectiveness of the CDS hedge on Greece would put into question the credit protection they have purchased on other sovereigns.

A final determination of a Greek credit event rests with ISDA's EMEA Determinations Committee. But several negative credit effects follow for banks if the effectiveness of CDS protection on sovereigns becomes questionable. They include the following:

- The value of CDS protection on sovereigns would decline
- Bank credit reporting would be inaccurate. Many banks manage and disclose their credit positions on a net basis[12] after deducting, among other things, the CDS protection they've purchased
- Increased sovereign exposure on banks' balance sheets could result in greater capital requirements and a further crowding out of other creditors
- Sovereign borrowing costs would increase as banks lose an effective means of dispersing risk
- Other issuers would also face higher borrowing costs if macro risks can no longer be effectively hedged via sovereign CDS
- Price discovery and liquidity would be hampered as the number of participants in the sovereign CDS market would be reduced

The impact on banking systems or individual banks depends on the size of exposures and whether those banks are net sellers or net buyers of CDS protection. Our analysis indicates that German and Italian banks are very active in non-Aaa-rated euro area sovereign CDS,[13] with gross outstanding notionals of €46.9 billion and €18.8 billion, respectively, at the first half of 2011. As such, they would be very exposed to a revaluation of sovereign CDS.

For example, on a system-wide and net basis, German banks during first-half 2011 sold approximately €15 billion worth of credit protection on non-Aaa-rated euro area sovereign debt. Deutsche Bank's (Aa3 stable; C+/A2 stable)[14] third-quarter interim results show that the bank remains a sizable seller of CDS protection, with a €2.3 billion net notional exposure to non-Aaa-rated euro area sovereign CDS.[15] Therefore, German banks, as a group, would be the greatest beneficiaries if a distressed exchange does not lead to payments under CDS contracts.

On the other side, the net effect for Swiss and French banks would be negative by €9.4 billion for Swiss banks and €1.1 billion for French banks. For example, UBS (Aa3 review for downgrade; C/A3 review for downgrade) showed a difference of CHF3.2 billion between its gross and net exposure to

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[11] Bloomberg TV's Inside Track with Erik Schatzker. In addition, ISDA released a statement on their website confirming Mr. Geen's comments.
[12] See ISDA Reminds Banks There Is No Such Thing as a Perfect Hedge, 1 August 2011.
[13] Data includes banks' exposure to sovereign debt in domiciled country.
[14] The bank ratings shown in this article are the bank's deposit rating, its standalone bank financial strength rating mapped to the long-term scale, and the corresponding rating outlooks.
[15] Deutsche Bank third-quarter 2011 report.

non-Aaa-rated euro area sovereigns, although this may also include some other forms of hedges offsetting their gross exposure.[16]

The exhibit below summarises European bank exposure to non-Aaa euro area sovereign debt. The first column indicates the banks' overall net cash exposure to non-Aaa rated euro area sovereign debt; the second column shows the banking sector net CDS position (positive numbers indicate CDS protection sold, negative numbers indicate that the banking sector is an overall buyer of protection). The final column shows banks' total exposure (adding the first and second columns, that is, the cash and derivatives instruments added together).

Non-Aaa-Rated Sovereign Exposure Among European Banking Systems

Banking System	Net Cash Exposure to Non-Aaa Sovereigns	Net CDS Exposure to Non-Aaa Sovereigns	Net Cash and CDS Exposure to Non-Aaa Sovereigns
Austria	3,497	1,913	5,410
Baltics	6	0	6
Belgium & Luxembourg	76,234	121	76,354
Bulgaria	0	0	0
Cyprus	5,697	28	5,724
Czech Republic	968	0	968
Denmark & Faroe Islands	218	190	408
Finland	1,036	0	1,036
France	97,570	-1,107	96,463
Germany	87,548	14,981	102,529
Greece	42,011	0	42,011
Hungary	0	0	0
Ireland	42,259	0	42,259
Italy	133,171	1,388	134,560
Netherlands	22,892	-351	22,541
Norway	8	0	8
Poland	0	0	0
Portugal	21,461	414	21,874
Romania	0	0	0
Slovakia	238	0	238
Slovenia	448	0	448
Spain	138,871	-11	138,860
Sweden	1,199	8	1,207
Switzerland	4,399	-9,352	-4,953
United Kingdom	36,396	-32	36,364
Total	**716,128**	**8,189**	**724,317**

Note: Data compiled by Moody's in first-half 2011 via a survey of approximately 250 rated banks.

Source: Company reports, Moody's

[16] UBS third-quarter 2011 report.

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Expanded Assistance to Greece Relieves Some Pressure, but Significant Risks Remain

In the early hours of 27 October, European policymakers reached an agreement on a range of additional measures to support banks and sovereigns in the euro area. While the announced debt relief and additional financial assistance relieves some fiscal and economic pressures on the Greek sovereign, the country continues to face daunting credit challenges.

The new agreement included a revised funding programme for Greece, including a default in the form of a "voluntary" exchange and 50% par haircut on privately held Greek debt. The public sector also agreed to increase its programme funding by a further €100 billion through 2014, and to strengthen the institutional structures responsible for monitoring implementation of the Greek programme. There will now be enhanced programme monitoring staff located in Greece who will work with Greek authorities on implementation of the memorandum of understanding between the Greek government and the Troika (European Central Bank, International Monetary Fund, and the European Commission). Having monitoring staff on hand is likely to mitigate some of the implementation problems that have contributed to the deterioration of Greece's public finances and macroeconomic performance.

The 27 October announcement is also supportive of Greek banks because the negative news of a big haircut was offset by greater clarity around the availability of a "back stop" capital buffer. This reduced uncertainty should go some way toward increasing confidence in the solvency of these institutions, though implementation risks, further provisioning needs from loan book deterioration, and persistent liquidity pressures still weigh heavily on the sector.

While the deeper par haircut relieves some pressure on the Greek sovereign, it is not a complete solution to Greece's solvency problems. The debt burden will remain very substantial after a successful execution of the private debt exchange. By officials' own estimates, the Greek debt stock will still be around 120% of GDP in 2020.

Even this debt level may be difficult to achieve by 2020 given the formidable challenges facing Greece. The three most important challenges include:

1. **Growth.** There is considerable uncertainty around Greece's future potential growth rate. The original memorandum of understanding contained a substantial number of structural economic reforms designed to increase the country's long-term growth, but implementation of these reforms lagged expectations. Greece is currently going through a very deep recession and the growth rate it can achieve and sustain on an ongoing basis will probably be uncertain for at least the next few years.

2. **Implementation risk.** Greece has had great difficulty implementing the large-scale structural economic and fiscal reforms that are necessary to increase revenues, achieve efficiency savings, and make its debt burden sustainable. Although increased implementation and monitoring assistance from euro area experts will go some way toward mitigating this risk, responsibility for implementing the reform programme ultimately lies with Greek officials and therefore residual implementation risk remains given the country's weak institutional capacity.

3. **Privatisation.** The Greek €50 billion privatization programme was always ambitious and the escalation of the country's sovereign crisis has made it even more difficult to encourage investors to purchase state-owned assets. The 27 October announcement includes a requirement that Greece commit future privatization-related cash flows in excess of those already included in the adjustment programme (up to €15 billion) to increasing the lending capacity of the European Financial Stability Facility.

Given the difficult tasks that still lie ahead for Greek authorities and the quantity of debt that will likely remain at the end of this decade, the possibility of a further haircut for bondholders remains substantial. This is not uncommon; in the sample of sovereign defaults we studied, 70% of the countries that defaulted experienced multiple defaults within a few years. It is also common for a defaulting sovereign's credit quality to remain poor after its default. The median defaulter's rating was Caa1 two years after its first default, and B3 three years afterward.

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Greek Debt Haircut and Recapitalization Commitment Reduce Uncertainty, but Greek Banks' Challenges Persist

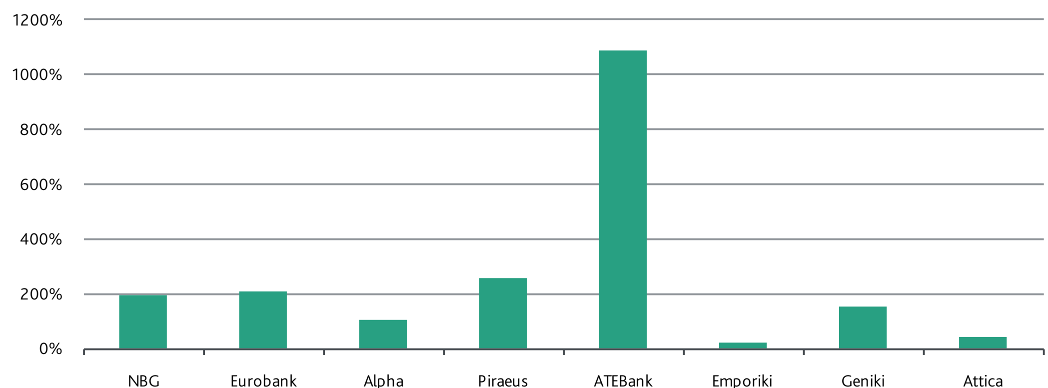
Last Thursday, European leaders reached a deal with Greek bondholders whereby private investors will take a 50% haircut on Greek government bonds (GGBs). As Greek commercial banks have the highest relative exposure to GGBs among European banks, we estimate their losses will amount to €15-€25 billion and essentially render most banks insolvent. Concurrently, the European Union reiterated its commitment to finance bank recapitalizations, which will be needed as neither shareholders nor the Greek government can bail out the Greek banks.

While the haircut, along with the EU commitment to finance bank recapitalizations, reduces uncertainty, Greek banks continue to face significant challenges. Among them are implementation risks associated with the plan, further provisioning needs arising from loan book deterioration, and persistent liquidity pressures.

Last Thursday's agreement supersedes an Institute of International Finance (IIF) announcement on 21 July, whereby the private sector agreed to a voluntary write-down of GGBs that resulted in Greek commercial banks recognizing a €5.9 billion charge, equal to an average haircut of 16%-17%. Losses on a 50% haircut will depend on the type of instruments subject to the haircut.

If the haircut applies only to GGBs, as the IIF's announcement did, we estimate Greek commercial banks' losses would amount to around €15 billion (without adjusting for losses on a net present value basis). If the haircut applies to all Greek debt (including T-bills, government loans, etc.), we estimate losses at up to €25 billion.[17] By comparison, we estimate Greek commercial banks' Tier 1 capital to be €27 billion, and their Tier 1 capital ratio to be 9.6% as of June. Exhibit 1 shows rated banks' exposures to GGBs and T-bills as a percentage of Tier 1 capital.

Greek Banks' GGBs and T-bills As Percent of Tier 1 Capital - June 2011



Source: Moody's, banks' financial statements and presentations

In addition to the capital needs arising from the government debt haircut, banks will have to increase provisioning against continued deterioration in loan portfolios. Non-performing loans (NPLs) have already risen to 12.8% in June from 4.5% at the end of 2007. In order to bring provisioning coverage up to the 62% of NPLs recorded in 2006 from the current level of around 46%, we estimate that the

[17] If a 20% deferred tax credit is still applicable, these figures would amount to €12 billion and €20 billion, respectively, rather than €15 billion and €25 billion.

banks need an additional €5 billion. The Bank of Greece has hired BlackRock Solutions to assess the accuracy of banks' NPLs and assess provisioning needs, and those results may indicate requirements beyond our current estimate.

The sheer size of Greek banks' recapitalisation needs suggests neither shareholders nor the Greek authorities can meet those needs. As such, we expect recapitalisation support to come from the so-called Troika (the International Monetary Fund, the European Central Bank (ECB) and the European Commission) via a €30 billion commitment to the Hellenic Financial Stability Fund (HFSF), which will effectively lead to widespread nationalizations.

Though the reiteration of the EU's recapitalization commitment removes some uncertainty, we do not expect liquidity pressures for Greek banks, their other key pressure point, to abate in the near term. The banks are still structurally dependent on the ECB for their liquidity needs, as deposits have shrunk by about 23% since October 2009, and remain vulnerable to accelerated outflows if implementation problems arise. The extent of liquidity pressures recently necessitated the activation of Emergency Liquidity Assistance (ELA) from the Bank of Greece.

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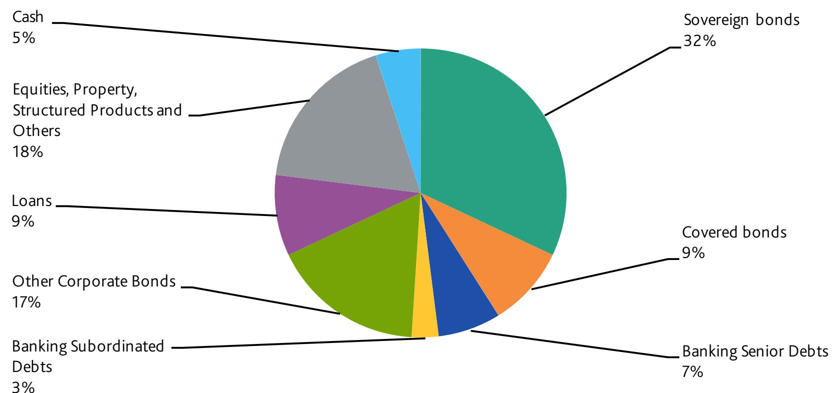
Despite Greek Debt Haircut, EU Summit Decisions Are Mildly Positive for European Insurers

On Thursday, European Union (EU) leaders announced several measures to restore market confidence in euro area countries. These measures include an additional haircut on Greek sovereign bonds. The additional haircut does not materially affect insurers, but if and to the extent that the EU's decisions stabilize the credit quality of sovereigns and banks, they are credit positive for insurers, which will benefit as large creditors of these issuers.

Impact on insurers hinges on whether EU decisions strengthen sovereign and bank credit profiles. European insurers are indirectly affected by EU governments' decisions to recapitalize European banks and strengthen the European Financial Stability Facility (EFSF), given they hold just shy of one third (32%) of their investments in sovereign debt as of year-end 2010, 10% in banking debt and 9% in covered bonds, and they also own shares of banks (see Exhibit 1 below). We see mildly credit-positive implications from the EU summit for banks, while the implications for various euro area sovereigns mostly range between neutral and negative.[18]

In the case of banks, we believe the effects on insurers' asset profiles will be positive, as the mildly-positive credit implications offset the negative effects from potential participation by insurers in the banking sector recapitalization through lower dividends, participations in banks' capital increase, or any future junior debt restructuring and debt/equity swaps the banks initiate.

EXHIBIT 1
Investments of Rated European Insurers as of 31 December 2010



Source: Moody's

The 50% haircut on Greek bonds has only a marginal negative effect on our rated European insurers. As Greek sovereign debt accounted for only 0.3% of their investment portfolios as of 30 June, the effect of the haircut on Greek bonds will be marginal. We believe the financial effect on our rated insurers' will be less than 1% of their shareholders' equity on average, even if insurers had to take further losses on Greek bonds.[19] In addition, although the recognition of losses on their Greek bond portfolio could have a negative effect on returns that life insurers will be able to return to policyholders, we believe this should not be a material issue for most groups, and does not threaten their long-term competitiveness.

[18] See Euro Area Summit – Summary of Key Credit Implications, 28 October 2011.
[19] See European Insurers: EU Sovereign Pressures Have Limited Impact on Credit Profiles So Far, 20 October 2011.

Most European insurance groups report under IFRS, with virtually all government bonds classified in the available-for-sale (AFS) category. Therefore, based on market values at the end of June, a loss of more than 50% on Greek bonds is already accounted for in insurers' shareholders' equity, and an impairment of 50% would only result in a transfer from AFS reserves to the profit and loss statement, hence limiting the effect on insurers' capitalisation.

Furthermore, after the Institute of International Finance (IIF) extended a first voluntary financing offer to the Greek government in July, some groups incorporated a haircut of around 50% as of 30 June, reflecting market value. These groups would recognize additional losses in their income statement only if the market value of Greek bonds is below their 30 June level. Groups that have impaired only part of their Greek bond portfolio to market value or those that impaired the bonds by only 21% only (in accordance with the IIF's earlier proposal) would have to recognize more losses.

Exhibit 2 details our expectations for additional impairments to be reported by the five rated insurance groups presenting the largest exposures to Greek sovereign bonds in absolute amount as of 30 June. On top of the figures presented in Exhibit 2, we expect additional impairments owing to the fall in market value of Greek bonds between the end of June and the end of September, the magnitude of which depends on the durations of bonds held.[20]

EXHIBIT 2

Reported and Expected Additional Impairments on Greek Bond Portfolio for the Main Rated Insurance Groups, € millions

	Impairments Reported as of 30 June 2011		Moody's Expected Additional Impairments Following 27 October EU Decisions*		
Insurance Group	Gross Impairment	Net Impairment**	Gross Impairment	Net Impairment**	Net Impairment as Percent of Shareholders' Equity
Ageas (financial strength A2 negative, for the main operating entity [1]	328	*~191 [1]*	~ 500	~ 350 [1]	~ 4%
Allianz (financial strength Aa3 stable) [2]	644	326	0	0	0%
AXA (financial strength Aa3 stable) [3]	224	92	~500	~150	< 0.5%
Generali (financial strength Aa3 negative) [4]	1,002	140	~450	~70	< 0.5%
Munich Re (financial strength Aa3 stable) [5]	703	125	0	0	0%

* Expected impairments do not take into account declines in Greek bond market values since 30 June 2011, and potential reduction of exposures since 30 June 2011.

** After policyholders' participation and tax

[1] As of 30 June, Ageas impaired at market value Greek bonds maturing before 2020 only; figures are our estimates of impairments before minority interests; the net impairment disclosed by Ageas at 30 June 2011 is €150 million, after minority interests. Last Friday, Ageas disclosed a further €353 million impairment, after minorities. This number also reflects the fall in Greek bond market value between 30 June and 30 September.

[2] As of 30 June, Allianz impaired its entire Greek sovereign bond portfolio at market value.

[3] As of 30 June, AXA impaired at market value Greek bonds maturing before 2020 only.

[4] As of 30 June, Generali impaired at market value Greek bonds maturing before 2020 only.

[5] As of 30 June Munich Re impaired its entire Greek sovereign bond portfolio at market value.

Source: Moody's, companies' reports and financial presentations

[20] Last Friday, Ageas disclosed that the market value of its Greek bond portfolio was at 38% of historical cost as of 30 September, versus 53% as of 30 June. This implies a reduction of 29% in market value.

Corporates

Smucker's Acquisition of Sara Lee Coffee Business Is Credit Positive

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The J.M. Smucker Company (A3 stable) said last Monday it signed an agreement to purchase for $400 million a majority of Sara Lee Corp.'s (Baa1 review for downgrade) foodservice business in North America. The deal is credit positive for Smucker because it will modestly strengthen the company's credit metrics, double the size of its foodservice business and expand its reach in the North American coffee market.

Smucker will pay $350 million in cash on hand at closing, which the companies expect will occur near the beginning of 2012, and an additional $50 million in declining installments over the next 10 years.

The immediate financial effect on Smucker will be modest as the acquired business' projected annual revenue of $285 million represents less than 6% of Smucker's consolidated revenue of $5 billion. We expect Smucker's pro forma credit metrics will improve slightly from the acquired earnings and cash flow, with debt-to-EBITDA falling to 2.1x from 2.2x, which was the pro forma for a recent bond offering and the retail coffee business it acquired in May from Rowland Coffee Roasters Inc. (unrated) for $360 million. Smucker's debt will remain unchanged at $2.1 billion and liquidity will initially decline as a result of the $350 million payment to Sara Lee, but will stay solid.

The acquisition includes Sara Lee's liquid-coffee concentrate business sold under the licensed Douwe Egberts brand, along with roast and ground coffee, cappuccino, tea, and cocoa products sold through foodservice channels in North America. Liquid coffee concentrate is coffee extract that is mixed with water to make coffee drinks, often in large volumes. Smucker will also license Sara Lee's Pickwick tea and Cafitesse coffee machine brands.

We believe the deal provides long-term strategic benefits that will eventually give Smucker the technology it needs to supply a liquid-coffee version of its Folgers coffee brand through foodservice channels, such as restaurants, hotels, hospitals, and schools and universities, should management decide to pursue this route.

Smucker and Sara Lee agreed to collaborate on liquid-coffee concentrate technology through a 10-year partnership. Liquid coffee is the only significant platform within the coffee segment where Smucker does not currently have a presence, and it could provide a meaningful growth engine for the mature and market leading Folgers brand.

Smucker's existing foodservice coffee business is modest in size, although the company has experience selling packaged coffee through retailers under its Folgers brand and Dunkin' Donuts license. Smucker's US retail coffee segment is the company's largest revenue contributor, accounting for around 40% of consolidated revenue and nearly half of operating profit in fiscal year 2011, which ended in April.

The acquisition nearly doubles the size of Smucker's overall foodservice-segment revenue, to about $600 million, adding critical size to leverage its cost structure. Competition within the foodservice category can be stiff, and this channel typically yields lower margins than retail sales. The strength of Smucker's existing coffee brands and those it's acquiring may provide moderate pricing power, however.

The transaction's credit implications for Sara Lee will be considered in our ongoing review for rating downgrade, which began in January after the company announced its plans to split into two separate companies and pay a special dividend. Since then, Sara Lee has sold several other businesses that will affect the profile of the resulting companies.

In addition to the sale of the liquid coffee business to Smucker, Sara Lee has recently sold its North American refrigerated dough business to Ralcorp Holdings Inc. (Baa3 stable), and its fresh bakery businesses in Spain and Portugal to Grupo Bimbo, S.A.B. de C.V. (Baa2 stable). In addition, the Department of Justice recently approved the sale of Sara Lee's North American Bakery business to Grupo Bimbo, with the stipulation that the Mexican bakery company would have to sell some assets post-closing.

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Sony's Buyout of Ericsson's Stake in Sony Ericsson Is Negative for Sony, Positive for Ericsson

Last Thursday, Telefonaktiebolaget LM Ericsson (Ericsson, A3 stable) agreed to sell its 50% stake in Sony Ericsson to its joint venture (JV) partner Sony Corporation (A3 review for downgrade) for €1.05 billion cash.

The transaction, which the companies expect to close by first-quarter 2012, is credit negative for Sony as the transaction's cost will delay a much-needed reduction of its leverage. The deal is credit positive for Ericsson as it ends its exposure to the volatile smartphone market and adds cash liquidity.

While Sony paid €1.05 billion for half of Sony Ericsson, the JV's actual valuation is difficult to assess, as Sony is also receiving certain intellectual property from Ericsson in the sale. Over the 10-year life of the JV, it has generated net income of about €1.5 billion and paid €1.9 billion in dividends, implying a relatively short payback period of 10 years or less if this performance is repeated.

However, Sony Ericsson's performance has been volatile over the years, reflecting demand swings for mobile phones, the varying success of individual phone models, and restructuring requirements. In 2010 and year-to-date 2011, Sony Ericsson has consumed cash (its cash flow from operations year to date was minus €524 million) and generated only modest operating income of €24 million. We estimate that Sony Ericsson's share of the smartphone market, which is highly competitive from both a price and technology standpoint, is only in the mid-single-digits by units.

Intensifying competition, the potential for further declines in smartphone prices, and a commoditization of the handset market will continue to put pressure on Sony Ericsson's earnings over the next several years. As a result, Sony may need to increase its investment in the venture to strengthen the smartphone business.

As of September, Sony Ericsson had €718 million in debt, so the purchase will worsen Sony's leverage by the consideration paid to Ericsson as well as by consolidating all of this debt onto Sony's balance sheet. Although the acquisition itself may not significantly increase Sony's leverage (adjusted debt-to-EBITDA ratio is currently over 3.00x), Sony Ericsson's market position will further complicate a timely reduction of Sony's leverage to below 2.75x.

Sony's complete control of Sony Ericsson will improve operational efficiency, but there is no guarantee that Sony can improve the smartphone venture's competitiveness and profitability. Rivals such as Apple (unrated) and Samsung Electronics (A1 stable) dominate this market, leaving Sony Ericsson with only a small share.

Ericsson will benefit from the transaction because of the cash proceeds, which enhance an already strong capital structure, and because it will release the company from possible future capital support requirements[21] aimed at mitigating Sony Ericsson's cash consumption. At the end of September, Ericsson had SEK76.9 billion (€8.5 billion) of cash and cash equivalents, or SEK35.2 billion (€3.9 billion) net of reported financial liabilities. It faces the $1.15 billion (€830 million) payment for the acquisition of Telcordia in fourth-quarter 2011.

[21] See Capital Support to Increase for Cash-Consuming Joint Ventures, 5 September 2011.

Infrastructure

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Southern Montana Electric Bankruptcy Is Credit Negative for US Generation and Transmission Cooperative Sector

On 21 October, the Southern Montana Electric Generation and Transmission (G&T) Cooperative, Inc., (SME, unrated) filed for bankruptcy protection owing to severe cash flow problems caused by increased power supply costs, reduced volume sales, disagreement among SME's member-owners to raise their rates, and various litigation proceedings.

The failure to raise rates to cover cash flow requirements shows that creditors cannot assume members of G&T cooperatives will act in their best interests. G&T cooperatives enjoy substantial rate-setting autonomy and creditors have expected increased operating costs to be met with a timely increase in rates, thereby avoiding stress in cash flow generation.

The sector is also defined by its strong contractual wholesale power supply arrangements with its member-owners, which are tasked with effectively managing and directing the G&T cooperative's strategy, especially with respect to long-term power supplies.

Although SME's board ultimately approved a rate increase, the increase was not timely and there was an insufficient liquidity cushion to allow time for the higher rates to take effect and cover the higher-than-anticipated costs.

Thus, SME's decision to file for bankruptcy protection raises the risk applicable to the entire G&T cooperative sector, including our 19 rated issuers, all of which are investment grade. Despite their strong investment-grade ratings, G&T cooperatives generally produce cash flow to debt ratios of less than 10% and maintain high levels of leverage, often in excess of 75%.

Given the thin margins of debt coverage and heavily leveraged balance sheets typical for the sector, the financial ramifications of not implementing timely and sufficient rate increases can be equally swift and severe for any G&T cooperative as they were for SME, especially when compounded by weak liquidity.

SME's bankruptcy filing is a stark reminder of the need for G&T cooperatives to secure adequate sources of liquidity, as most of the strong investment-grade rated G&T cooperatives have, for the most part, done in recent years.

Banks

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Expanded HARP Is Credit Positive for GSEs

Last Monday, the Federal Housing Finance Agency (FHFA) announced changes to the Home Affordable Refinance Program (HARP) designed to increase the number of borrowers taking advantage of the program. FHFA estimates that approximately 900,000 borrowers will refinance under the program between now and December 2013, when the program expires.

We believe expanded HARP is credit positive for Fannie Mae and Freddie Mac (the government-sponsored enterprises, or GSEs) because the program's reduction of credit losses will outweigh its decline in investment income. Expanded HARP will have a minimal effect on banks' profitability.

Established in 2009, HARP provides borrowers, who are current on their GSE mortgages but may not otherwise qualify for refinancing because of declining home values or deteriorated credit, the ability to take advantage of historically low mortgage rates and refinance their mortgages.

The key changes that were announced are the following: reducing fees, eliminating loan-to-value limits, relaxing lender representation and warranty exposure, eliminating full appraisals where appropriate, and extending the program to 31 December 2013.

GSE effect. Expanded HARP is credit positive for the GSEs because of its potential to positively affect income by reducing credit losses though lowering HARP borrowers' mortgage rates and, as a result, a borrower's debt service burdens. However, the reduced credit losses will be offset by lower investment income.

The following exhibits show our analysis on the effect that the expanded HARP will have on GSEs financial performance. Exhibit 1 estimates the size of expanded HARP as a percent of the GSE's total mortgage portfolio; Exhibit 2 analyzes the projected decline in income measured against 2010's net income; and Exhibit 3 calculates the level at which defaults need to decline in order for expanded HARP to be income neutral to the GSEs.

Exhibit 1 estimates the volume of loans through 2013 that may be refinanced through expanded HARP at approximately $135 billion, or 2.89% of outstanding GSE mortgages.

EXHIBIT 1
Scope of Expanded HARP ($ millions)

Estimated number of expanded HARP loans (a)	900,000
Average loan size (b)	$ 0.15
Estimated $ volume of expanded HARP loans (c = a*b)	$135,000
GSE mortgages oustanding as of August 2011 (d)	$ 4,673,623
HARP refinancings as a % of total GSE mortgages (e = c/d)	2.89%

Source: FHFA, Fannie Mae, Freddie Mac, and Moody's

Assuming mortgage rates decrease an average of 2% on the estimated 2.89% mortgages refinanced, Exhibit 2 estimates the decline in annual investment income at $327 million for Fannie Mae and $223 million for Freddie Mac, a small amount relative to the firms' 2010 net loss.

EXHIBIT 2

Estimated Annual Investment Income Decline ($ millions)

	Fannie Mae	Freddie Mac	Total
Estimated refinance % (a = Exhibit 1 e)	2.89%	2.89%	2.89%
Annual loan rate decrease (b)	2.00%	2.00%	2.00%
Oustanding investment portfolio (c)	$566,414	$385,461	$951,875
Estimated annual investment income decline (d = a*b*c)	$327	$223	$550
2010 Net loss attributable to stockholders (e)	$ 21,718	$ 19,774	$ 41,492
Investment income decline as a % of 2010 net loss attributable to stockholders (d/e)	1.51%	1.13%	1.33%

Source: Fannie Mae, Freddie Mac, and Moody's

As shown in Exhibit 3, expanded HARP would be income neutral to the GSEs if as few as $6.9 billion fewer mortgages defaulted, or 5.09% of the expected $135 billion additional HARP volume.

EXHIBIT 3

Breakeven Mortgage Default Analysis ($ millions)

	Fannie Mae	Freddie Mac	Total
Assumed average life (a)	5	5	5
Lifetime reduction in invesment income (b = Exhibit 2 d * a)	$ 1,636	$ 1,113	$ 2,750
Assumed severity (c)	40%	40%	40%
Breakeven mortgage default amount (d = b/c)	$ 4,090	$ 2,784	$ 6,874
Breakeven default amount as a % of estimated HARP volume (d/Exhibit 1 c)			5.09%
Breakeven default amount as a % of total mortgage portfolio (d/Exhibit 1 d)			0.15%

Source: FHFA, Fannie Mae, Freddie Mac, and Moody's

Because of its small size, we expect the expanded HARP to have a minimal effect on the housing market and overall economy. However, even a small effect, leading, for example, to a reduction in lifetime GSE defaults of 0.15% (see Exhibit 3) would go a long way to offsetting the reduction in investment income.

Bank impact. Expanded HARP will have a minimal impact on banks' profitability. Exhibit 4 quantifies the decrease in GSE mortgage-backed securities (MBS) investment income of the Big Four banks. As shown in the exhibit as a percentage of the banks' 2010 pre-tax, pre-provision income, the reduced investment income is a negligible 26 basis points (bps) for Bank of America, 5 bps for Citigroup, 17 bps for JPMorgan Chase, and 13 bps for Wells Fargo.

EXHIBIT 4

Impact on Big 4 Banks GSE MBS Investment Income ($ millions)

	Bank of America	Citigroup	JPMorgan	Wells Fargo
Estimated refinance % (Exhibit 1 e)	2.89%	2.89%	2.89%	2.89%
Annual loan rate decrease (b)	2.00%	2.00%	2.00%	2.00%
Outstanding investment portfolio (c)	$181,616	$ 36,206	$118,916	$ 78,338
Estimated annual investment income decline (d = a*b*c)	$105	$ 21	$ 69	$ 45
2010 Moody's adjusted PPI (e)	41,073	39,397	39,821	34,697
Investment income decline as a % of 2010 Moody's adjusted PPI (d/e)	0.26%	0.05%	0.17%	0.13%

Source: The banks, Moody's

As mentioned above, we expect the expanded HARP to have a minimal effect on the housing market and overall economy because of its small size. Nonetheless, even a small impact such as a reduction in lifetime bank credit losses of 4 bps to 9 bps (see Exhibit 5) would go a long way to offsetting the small reduction in investment income.

EXHIBIT 5

Lifetime Investment Income Reduction Versus Big-Four Banks' Consumer Credit Exposure ($ millions)

	Bank of America	Citigroup	JPMorgan	Wells Fargo
Assumed average life (a)	5	5	5	5
Lifetime reduction in investment income (b = Exhibit 4 d * a)	$525	$105	$343	$226
Outstanding consumer loan as of June 30, 2011[1] (c)	$611,863	$286,583	$440,692	$421,232
Lifetime reduction in investment income as a % of the outstanding consumer loan portfolio (b/c)	0.09%	0.04%	0.08%	0.05%

Note: [1] Outstanding US Consumer Loans for BAC, Citi and WFC; JPM only reports aggregate outstanding consumer loans

Source: The banks, Moody's

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Effect of Obama Student Loan Program Is Modest, but Political Risk Looms

Last Tuesday, the Obama administration announced its “Help Americans Manage Student Loan Debt” program, which allows students who have both FFELP[22] loans and Department of Education Direct Loans to move their FFELP loans to the Direct Loan program and reduce their rate by 25 basis points. The cost of the program to student lenders such as SLM (Ba1 stable) and Nelnet (Ba1 stable), which may lose some of their federally guaranteed student loan portfolio, is likely to be small. But the specter of political risk continues to hover over the student loan business and this is credit negative.

The Department of Education program, known as the Special Direct Consolidation Loans program, begins in January 2012 and ends 30 June 2012. To be eligible for the program, an individual must have at least one student loan held by the Department of Education (e.g., under its Direct Loan program) and at least one loan made under the FFELP program by student lenders such as SLM and Nelnet.

Individuals consolidating into a Special Direct Consolidation Loan will receive a 25-basis-point reduction in the interest rate on their FFELP loan as of the date of consolidation. However, the maturity date on the new consolidation loan will remain the same as the individual’s original maturity date and will not be extended.

The risk to student lenders such as SLM and Nelnet is that FFELP loans will be “consolidated away” by the new program, depriving these companies of the related earnings and cash flow. However, this risk is modest. We use SLM as an example and assume that FFELP loans funded in the Straight A conduit facility provided by the government serve as a proxy for eligible loans under the new program. For SLM, this amount totaled $18 billion[23] at 30 September and equates to approximately 13% of SLM’s total FFELP portfolio and approximately 10% of its total student loan portfolio, including private education loans. Even assuming that the program consolidates away 100% of such FFELP loans, we estimate the impact on SLM is less than 6% of consolidated net income.[24]

Yet, it is unlikely that 100%, or even close to that amount, will be consolidated away because the combination of the modest interest-rate reduction and the fact that the maturity date is not extended means that the student’s monthly payment would decline only slightly. For instance, assuming a $10,000, 10-year FFELP Stafford loan at 6%, the 25-basis-point reduction would reduce monthly payment by approximately $1.25, hardly a meaningful amount. Therefore, the financial impact on student lenders like SLM is likely to be much smaller than the above estimate.

The broader issue is the fact that despite the elimination of the FFELP program in 2010, political risk continues to hang over the student loan business. Political risk is certainly nothing new for the student lenders, whose business model has been materially transformed in recent years via legislation.

The College Cost Reduction and Access Act of 2007 slashed government subsidies to the FFELP program, substantially reducing the profitability of the program for lenders. And the Health Care and Education Reconciliation Act of 2010 disbanded the FFELP program outright.

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[22] Federal Family Education Loan Program (FFELP) was disbanded on 1 July 2010. Since then, all federally guaranteed student loans have been made under Department of Education’s Direct Loan program.

[23] Excludes ineligible loans acquired from Citibank.

[24] We arrive at that figure based on 13% of the SLM portfolio multiplied by $407 million (the last-12-months FFELP segment net income minus the gain on sale to Department of Education under Loan Purchase Commitment Program), divided by estimated 2011 net income $931 million ($1.80 per share), which equals 5.7%.

More recently, the high level of student loan debt is getting more public attention, and thus attention also from politicians, providing the backdrop for the president's "Help Americans Manage Student Loan Debt" proposal and raising the possibility that larger and more comprehensive student debt relief measures lie ahead. Any significantly larger student debt relief initiatives would likely require congressional approval.

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Belarus Ruble Devaluation Reduces Bank Capital Adequacy

On 20 October, the Belarusian ruble's official rate lost 34% of its value against the basket of major currencies[25] following the unification of two separate trading markets[26] and the acknowledgement of the market currency exchange rate as the National Bank of Belarus' (NBB) official rate. We consider this move as credit negative for the Belarusian banking system, and particularly for banks with high levels of foreign currency-denominated loans.[27]

Our assessment is based primarily on two factors. First, the adjustment of the Belarusian ruble's official rate means that domestic companies will now face higher costs (in the local currency) for crucial imports such as energy. In other words, they lose the subsidy implied before in the below-market official exchange rate. Some borrowers that previously benefited from this implicit subsidy will find it more difficult to service their debt, which will weigh on bank asset quality.

Second, from an accounting perspective, the new official rate means that foreign currency assets and liabilities (which are largely matched for most banks) increase. While this has only a small effect on recorded capital levels, it increases banks' risk-weighted assets and therefore weakens their capital adequacy ratios (capital/risk-weighted assets).

Although this step merely acknowledges the economic reality of the weakened Belarusian ruble, it creates issues for banks that may be at risk of falling below the minimum 8% regulatory capital adequacy ratio.

The banking system's overall capital adequacy will fall to 14.0% from 16.9% (as reported by the NBB at the end of September 2011) as foreign currency-denominated loans will be recalculated at the new exchange rate, which could result in some banks falling short of local mandatory capital adequacy ratios. In the exhibit below, we divide all rated Belarusian banks by their capital adequacy level's vulnerability to currency movements into three categories: high, moderate and low susceptibility.

Susceptibility of Belarusian Banks' Normative Capital Adequacy to Foreign Exchange Movements

Bank	CAR's Vulnerability to FX movements	Normative Capital Adequacy at October 2011	FX loans % Total Loans at Year End 2010	Ratings[4]
Belarusbank	Moderate	12.8%	19%	Caa1 review for downgrade; E+/B3 review for downgrade
Belagroprombank	Low	21.7%	15%	Caa1 review for downgrade; E+/B3 review for downgrade
BPS-Sberbank	High	9.5%	48%[2]	Caa1 review for downgrade; E+/B3 Negative
Belinvestbank	High	10.8%	27%	Caa1 review for downgrade; E+/B3 review for downgrade
Bank Moscow-Minsk	High	14.0%	52%	Caa1 review for downgrade; E+/B3 review for downgrade
Minsk Transit Bank	Low	24.3%[1]	36%	Caa1 review for downgrade; E+/B3 review for downgrade
Banking system, overall	Moderate	16.9%	31%[3]	

[1] Data as at 1 September 2011

[2] Data as at 1 July 2011

[3] Data as at 1 October 2011, under local GAAP reporting standards

[4] The bank ratings shown in this article are the bank's foreign currency deposit rating, its standalone bank financial strength rating mapped to the long-term scale, and the corresponding rating outlooks.

Sources: National Bank of Belarus, banks

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[25] The basket containing the US dollar, euro, and Russian ruble is calculated and published by the National Bank of Belarus.

[26] Since September 2011, the Belarusian ruble has traded in two separate markets, an official one, in which trades were restricted to certain goals (payments for energy import and other high-priority needs) and conducted at below-market rates determined by the central bank, and a supplemental one, in which trades were conducted on a fully market basis. Results of the supplementary session served as an indication of the real value of the Belarusian ruble. However, the NBB did not recognise those values as the as the official rate until the two markets were unified on 20 October.

[27] The share of foreign-currency denominated loans amounted to 31% of total banking system's loans at the end of September 2011.

If banks with high susceptibility to FX fluctuations (BPS-Sberbank, Belinvestbank, and Bank Moscow-Minsk) do not increase their capital, or alternatively, if they do not reduce their credit exposures, their capital adequacy buffers might become insufficient to be commensurate with their current ratings level and, in some cases, the local mandatory capital adequacy ratio of 8% would be breached.

However, the NBB said it might waive regulatory sanctions for breaching capital adequacy requirements, introducing instead a timeframe for banks to gradually replenish their capital.

Although Belagroprombank and Minsk Transit Bank are comparatively better able to weather adverse shifts in currency rates, the current circumstances of the economic crisis in Belarus mean that external support is becoming a more important credit factor for all banks in the country.

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India's Deregulation of Savings Interest Rates Will Reduce Banks Profitability

Last Tuesday, the Reserve Bank of India (RBI), the country's central bank, deregulated interest rates on savings accounts. Banks are now free to set their own interest rates subject to two conditions: the same rate must be applied to balances up to INR100,000 ($2,000) and tiered rates can be offered for balances greater than INR100,000, but there cannot be customer discrimination for balances of similar size.

At the same time, the central bank raised its repo and reverse repo rates by 25 basis points to 8.5% and 7.5%, respectively. We believe these moves will hurt banks' profitability and thus are credit negative.

Savings deposits now account for almost a quarter of system deposits. For decades, RBI has been setting interest rates on savings accounts and, starting last May and right up until this move, the rate was 4%. In contrast, time deposits generally carry much higher nominal interest rates of 8.5%-9.5%. Amid the current inflation of nearly 10%, this implies that savers have substantial negative real return on their savings deposits.

As a result, we believe that a direct consequence of this policy is that banks can, and will, offer higher interest rates to compete for savings deposits, thereby undermining the role these deposits play as a relatively stable and low-cost funding source. We expect the move to exacerbate already increasing pressure on net interest margins and asset quality.

We expect public-sector banks to be the ones most negatively affected by this development. Collectively, they hold just over half of the system's savings deposits thanks to their large and wide branch networks across the country.

For example, State Bank of India (Ba1 stable; D+/Baa3 stable),[28] the country's largest bank, controls 20% of system deposits with savings accounts making up a third of its deposit base. With deregulation, it is likely that public-sector banks will need to pay significantly higher interest to maintain their deposit base, notwithstanding their distribution advantage in the rural areas.

Conversely, private banks, which are perceived to offer superior customer service and more advanced information technology, will use this pricing freedom as a new tool to gain market share. This is especially true for the newer and smaller players that are especially keen to develop stable funding bases. Yes Bank (Ba1 stable; D+/Ba1 stable), for example, has announced that it will raise savings interest rates by 200 basis points to 6%.

Competitive pressure also makes it unlikely that the banking sector (including private and public banks) will be able to pass on the entire increase in funding costs to borrowers, implying narrowing interest margins ahead. And, to the extent that banks do raise lending rates to mitigate their increased funding costs, borrowers' debt-servicing capability and banks' asset quality will be undermined.

The rule change won't help life insurers, either. Bank deposits, which offer higher interest rates and greater liquidity, are apt to lure some customers away from buying savings-type insurance products. We do not expect any positive effect on insurers' investment income because bank deposits account for only a tiny portion of their portfolio, and insurers, as corporations, are allowed to keep money only in current account (earning zero interest) or term deposits, which already command higher negotiated interest rates.

[28] The bank ratings shown in this report are the bank's deposit rating, its standalone bank financial strength rating mapped to the long-term scale and the corresponding rating outlooks.

RBI's determination to control the country's persistent inflation is underscored by its recent rate rise, the 13th since March 2010, in spite of a slowing economy. India's inflation is hovering near 10% against the central bank's target range of 5%-6%. The higher cost of funds will further pressure banks' net interest margins, which have already been declining in the rising interest rate environment.

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Flood Damage Spreads to Thailand's Banks, a Credit Negative

The past week saw a marked escalation in Thailand's floods. Last Tuesday, floodwaters reached Don Muang Airport, one of Bangkok's two airports, shutting down commercial flights there. The floods, which started in the northern provinces in July, now threaten to inundate the city center. We expect continuing flood problems to be credit negative for Thai banks as the emerging damages and disruptions are poised to adversely affect asset quality and profitability for at least six months. While no government data has been published, initial estimates from major Thai commercial banks suggest that up to 1% of their outstanding loans would be directly affected, and another 5%-8% indirectly affected.

Estimated economic costs are substantial and rising. Our sovereign team estimates the disaster's economic costs already exceed THB200 billion (2% of GDP), and if the floodwaters spread to downtown Bangkok, the estimate may increase. As the flood spreads, it is also claiming industrial casualties in agriculture, manufacturing, logistics, services and tourism. The Don Muang Airport shutdown also suggests that the flood has disrupted a substantial portion of the country's distribution network, which would hurt economic activities even in areas not directly threatened by the inundation.

We expect this disruption to add to recent deterioration in the external demand outlook and pose a significant drag on GDP growth in second-half 2011. Our sovereign team expects real fourth-quarter GDP to contract in annual and quarterly terms, and forecasts full-year GDP growth at 2.8%, down from the pre-floods estimate of 4.0%, and from the 7.8% actual GDP growth in 2010.

Banks are especially vulnerable to the small and midsize enterprise segment as the reported closure of a number of large industrial ventures (more than 400 Japanese auto manufacturers and electronics firms in six industrial parks north of Bangkok have been affected) could directly jeopardize many of their suppliers. We also expect bank profits to be affected by higher provisioning as well as repair costs to ATMs and other premises.

To contain the effect on the banking sector, the government has approved several emergency assistance measures, such as a THB325 billion flood rehabilitation package announced last Tuesday that comprises mostly soft loans (loans provided by the government and government-related entities that have low and below market interest rates, longer repayment periods, and interest holidays). We believe this will mitigate pressures on asset quality.

In addition, the Bank of Thailand (BoT), the country's central bank, has requested that banks assist affected customers through measures such as principal and interest grace and tenor extension, lower installments, reconstruction financing, and waiving selected fees and charges. The BoT also indicated that it will not classify flood-hit accounts as impaired for one year. We believe, on balance, asset quality will deteriorate in the next six months and that, as a result of policymakers' signaled forbearance, economic non-performing loans (NPLs) will be higher than reported NPLs.

Despite these credit negative developments, we expect the floods will not materially undermine banks' creditworthiness because the effects will be short lived and banks' asset quality was improving in the run-up to the disaster. Credit growth (the denominator effect) and recoveries on problem loans that have exceeded allocated provisions have driven improvements. Central bank data up to the end of June indicates that asset quality has improved across the commercial banking industry. NPL ratios steadily fell to 3.3% at the end of June from 5.3% at the end of 2009. Separately, the BoT estimated that Thai banks owned roughly half of the affected industries' debt, and that foreign financial institutions owned the remainder. As a result, there will be some degree of burden sharing from external creditors that will mitigate the effect on the domestic banking sector.

In addition, the sector's good capitalization buffers support the banks' resilience in this crisis. With an average Tier 1 ratio of 11.3% at the end of June 2011, we expect most banks to have sufficient capital to absorb losses from the current disaster, and to support a potential reconstruction-driven rebound in economic growth in 2012.

Insurers

Medicare and Medicaid Insurance Acquisitions Are Credit Positive for Purchasers

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An unusual flurry of acquisition announcements in the healthcare insurance sector last week highlights the current focus on diversity and government programs. Concerns regarding financing implications aside, three acquisitions announced last week all have positive credit implications for the purchasers as they expand an existing business segment, and, in two cases, result in a more diverse revenue stream.

Last Monday, CIGNA Corporation (Baa2 stable) announced it had entered into a definitive agreement to acquire HealthSpring Inc. (Ba3 stable). For CIGNA, which has primarily focused on the commercial segment, the acquisition of HealthSpring, which operates in the Medicare Advantage segment, provides significant diversity to both CIGNA's premium and earnings streams. This aspect of the deal, along with CIGNA's planned deleveraging over a relatively short time frame, balanced out the significant amount of additional debt and goodwill CIGNA will add to its balance sheet to fund the transaction.

Last Tuesday, AMERIGROUP Corporation (financial strength Baa3 stable) revealed it was purchasing the Medicaid membership of Health Plus, a New York not-for-profit managed care organization. When it completes the transaction, AMERIGROUP, which operates primarily in the managed Medicaid segment, will be one of the largest Medicaid managed care organizations in New York State.

Finally, last Wednesday, Coventry Health Care Inc. (Baa3 stable) reported that it intends to purchase the Medicaid business of Children's Mercy's Family Health Partners. This transaction will be an expansion of Coventry's Medicaid business into Kansas and Missouri and add approximately 200,000 Medicaid members to the current 467,000 Medicaid members served by Coventry. Neither AMERIGROUP's nor Coventry's transactions involved additional debt.

As health insurers assess the impact of the healthcare reform law, we expect them to continue to seek expansion and diversification opportunities. In particular, with the operational and financial challenges that loom ahead in the commercial segment under the Affordable Care Act, many healthcare insurers are seeking to build revenue and earnings streams in both Medicare Advantage and Medicaid managed care. However, these government entitlement programs are not without their own risks.

For both programs, the major risk is the level of reimbursement paid to the insurers by the government to cover the programs' health benefits. For the managed care Medicaid segment, as states fall under budgetary pressures, the challenge is the level of reimbursements states pay to healthcare insurers. Somewhat offsetting this risk, however, is that the healthcare reform law will provide increased federal funding for an expansion of Medicaid beginning in 2014.

With respect to Medicare Advantage, the issue is the change in federal government reimbursement levels under the Affordable Care Act. Under the healthcare reform law, reimbursement rates to health insurers that offer Medicare Advantage plans will be gradually reduced over several years.

It is not clear how current Medicare Advantage members will respond to the resulting benefit and premium changes that will likely result from these reduced reimbursement levels. However, even with the reimbursement cuts enacted to date, Medicare Advantage membership has continued to increase.

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Workers' Compensation Rate Increase Is Credit Positive for Florida Insurers

Last Monday, Florida Insurance Commissioner Kevin McCarty announced that he would approve the National Council on Compensation Insurance's (NCCI) 8.9% average rate hike request, effective 1 January 2012, for Florida workers' compensation insurance rates. The rate increase is credit positive for US property & casualty (P&C) companies with large Florida workers' compensation businesses, especially as the industry has experienced significant pressure from increasing underwriting losses and regulated premium rate declines over the past several years.

Exhibit 1 shows companies that write the largest amounts of workers' compensation insurance in Florida.

EXHIBIT 1
Top 10 Florida Workers' Compensation Companies

US Insurance Group	Moody's Insurance Financial Strength Rating	2011 Florida Workers Compensation Direct Premiums Written ($ millions)	2010 Market Share
Liberty Mutual	A2 stable	$4,073	11.4%
American International Group	A1 stable	3,130	8.8%
Travelers	Aa2 stable	2,820	7.9%
Hartford	A2 stable	2,643	7.4%
Zurich (Farmers)	A2 stable	2,331	6.5%
Ace	A1 stable	952	2.7%
Old Republic	A1 stable	853	2.4%
Blue Cross & Blue Shield of MI Group	unrated	743	2.1%
Chubb	A2 stable	714	2.0%
CAN	A3 stable	685	1.9%

Source: Highline Data and Moody's

Since the state passed legislative reforms in 2003, Florida has experienced a 61.9% cumulative decrease in its workers' compensation rates. While Florida consistently had some of the highest workers' compensation rates in the country prior to 2003, the state's rates have declined in six of the past seven years, as detailed in Exhibit 2.

EXHIBIT 2
Florida Workers' Compensation Rate Changes

Effective Date of Change	Florida Rate Change
1 January 2006	(13.5)
1 January 2007	(15.7)
1 January 2008	(18.4)
1 January 2009	(18.6)
1 January 2010	(6.8)
1 July 2010	(4.2)
1 January 2011	7.8

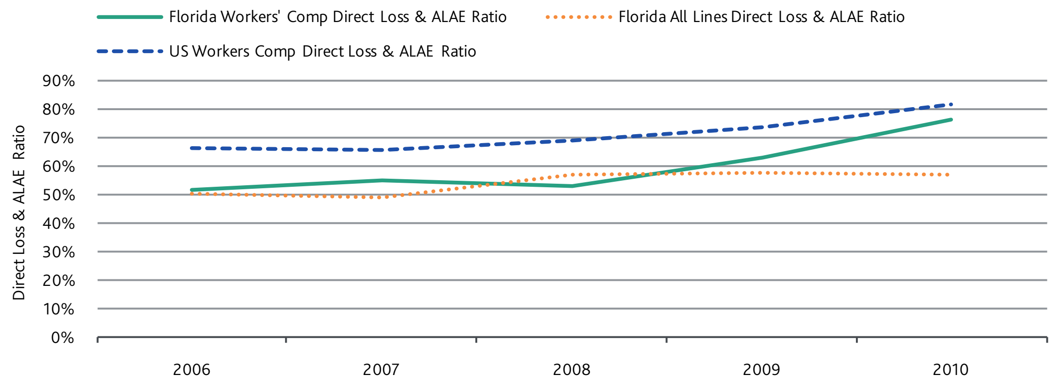
Source: Florida Office of Insurance Regulation, 2010 Workers' Compensation Annual Report, December 2010

The latest rate increase is particularly important for Florida, the seventh-largest state in terms of workers' compensation direct premiums written, given that nationally the industry paid $1.16 (116% combined ratio) in aggregate losses and expenses for every $1.00 received in premium in 2010, significantly worse than the more-or-less breakeven result of 101% in 2008.

While companies do not disclose workers' compensation combined ratios for specific states, they do disclose direct (e.g., before reinsurance) workers' compensation losses and allocated loss adjustment expenses (ALAE) by state.[29]

Exhibit 3 shows the trend of direct insurance losses and ALAE as a percentage of Florida workers' compensation for the industry. As a comparison, direct loss ratios for all P&C insurance lines of business in Florida and workers' compensation for all states in the US are also shown in the exhibit.

EXHIBIT 3
Florida Workers' Compensation Loss Cost Trends
(Loss and Allocated Loss Adjustment Expenses as a Percentage of Premium)



Source: Highline Data

While workers' compensation results in Florida are better than national workers' compensation market results, Florida workers' compensation has deteriorated faster than workers' compensation nationally over the past three years, and much faster than Florida P&C business overall, as detailed in the exhibit. Clearly, any rate increase to help offset rising losses is positive.

[29] Workers' compensation loss expenses primarily consist of medical and wage replacement, whereas allocated loss adjustment expenses primarily consist of legal costs.

Sovereigns

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Latvia's New Coalition Government Is Confirmed, a Credit Positive

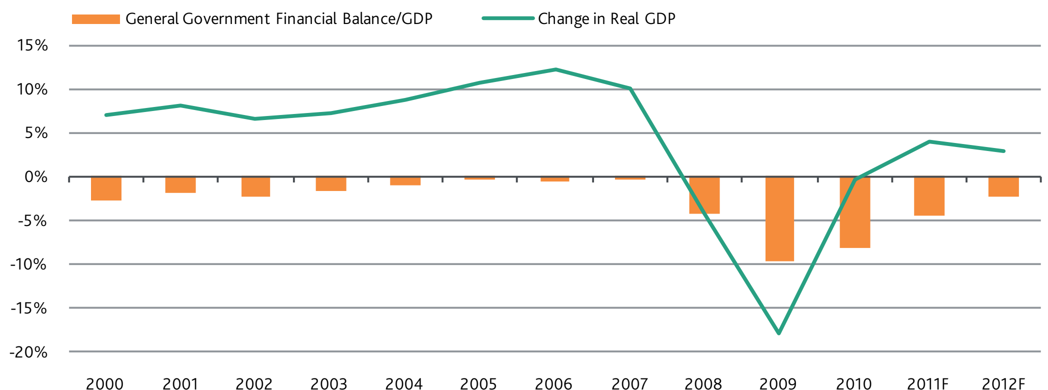
Last week, a coalition government was installed in Latvia (Baa3 positive) after more than a month of intense negotiations following 17 September elections. On Tuesday, Prime Minister Valdis Dombrovskis won a parliamentary confidence vote allowing him and his three-party coalition to form a government five months after the May dissolution of parliament. The re-election of Prime Minister Dombrovskis for a third consecutive term is credit positive for Latvia because it provides policy continuity, and importantly, cohesive views between the leaders of the coalition parties, especially the prime minister's Unity Party and the Reform Party, on broad economic policies.

The coalition consists of the Unity Party, which came in third with 20 seats, the Reform Party (of former President Valdis Zatlers) with 22 seats, and the National Alliance with 14 seats. Together they make up 56 seats in the 100-seat parliament. The single-largest party in parliament is the Harmony Centre party, representing the Russian minority, which will remain in the opposition.

Latvia's citizens generally accept the ongoing need to restructure and deleverage the economy, and the formation of the coalition government eases market concern about Latvia finding responsible ways to navigate a slower growth environment next year.

Latvia's public finances were hit hard by the 2008-09 financial crisis. As the exhibit below reflects, economic growth has averaged 8% since 2000, and the country ran manageable deficits well below 3% of GDP. But in 2009, the general government deficit widened to 9.7% of GDP from 0.3% of GDP in 2007 as tax revenue collapsed during the economic contraction and government stepped in to support the banking sector. Prime Minister Dombrovskis and his team adhered to a strict reform program, arresting the deterioration in the fiscal deficit in 2010 despite a lacklustre rebound in GDP growth. The administration further reduced the deficit in 2011, regaining the international community's confidence.

Latvia Budget and GDP Growth Trends



Source: Moody's

The government estimates that it undertook a fiscal adjustment of 17% of GDP over four years beginning in 2008. These included politically unpopular actions such as significant cuts in public sector wages and pension benefits. These measures reduced the budget deficit to 4.5% of GDP in 2011.

In the next few weeks, preparing and passing the 2012 budget will test the coalition. Prime Minister Dombrovskis promises to adhere to the target of reducing the fiscal deficit to 2.5% of GDP in 2012, paving the way to join the euro in the coming years. Yet, with around 40% of the new parliament being first-time members, maintaining the reform agenda will be challenging. The 2012 budget is due to be presented to the parliament in December.

Political Crisis and Prospects of Economic Sanctions Are Credit Negative for Lebanon

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Last Monday, Maura Connelly, the US Ambassador to Lebanon, warned of "serious consequences" if the Lebanese government fails to cooperate with and fund the Special Tribunal for Lebanon (STL). Any sanctions, particularly if they are aimed at the banking sector, are credit negative for Lebanon, which relies on its banks' capacity to attract deposits and buy government debt.

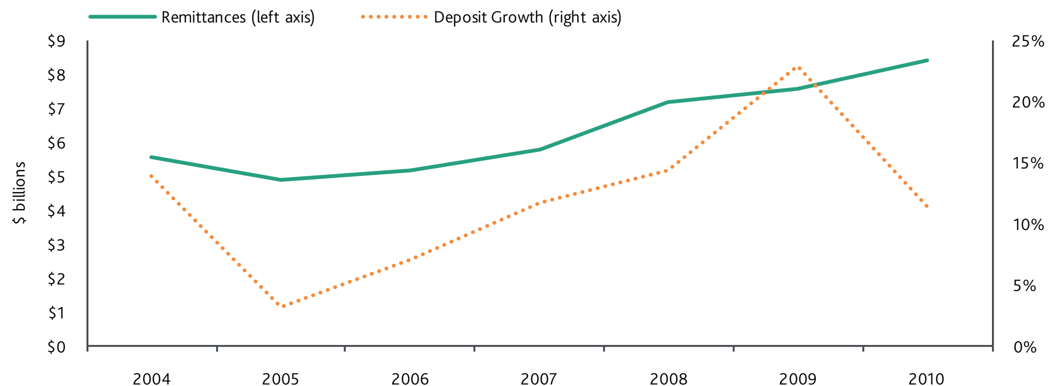
The STL was established in March 2009 with the purpose of holding trials for the people accused of carrying out the attack on 14 February 2005 that killed 23 people, including the former prime minister of Lebanon, Rafiq Hariri. The STL published its findings in June, charging four Hezbollah members and reviving tensions between communities within Lebanon. The current Lebanese government has to manage competing pressures from its domestic political base, which rejects the STL's role and findings, and concerns about possible international sanctions.

A decision to fund the STL could lead to a domestic political crisis, and potentially a fall of the current government. The dispute over the STL already caused the resignation of the previous government in January 2011, which was followed by five months of negotiations over the composition of the cabinet. The country is required to transfer $32 million, or 49% of the STL's annual budget to the United Nations. Failure to fund the STL could lead to economic or financial sanctions from the international community.

While sanctions appear unlikely, potential consequences could be severe. The stability of the Lebanese banking sector rests largely on banks' capacity to attract a stable inflow of customer deposits. In early 2011, US authorities accused Lebanese-Canadian Bank (LCB, unrated) of money laundering and subsequent sanctions on the bank triggered a run on its deposits. Customer deposits fund 83% of Lebanese banking system assets, and are supported by remittances, which account for over 20% of Lebanon's GDP.

The exhibit below shows the rise in recent years of both deposits and remittances. Sanctions that reduce the inflow of remittances or deposits could pose a threat to the stability of the banking system and the sovereign's finances. Lebanese banks are the main lenders to the highly indebted Lebanese sovereign and their capacity to fund government debt depends on the stability of their depositor base.

Lebanese Remittances and Deposits Have Continued to Grow



Source: Central Bank of Lebanon, World Bank

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India's Savings Deposit Rate Liberalization Improves Monetary Policy Transmission

Last Tuesday, the Reserve Bank of India (RBI) deregulated interest rates on savings deposit accounts in Indian commercial banks. Rather than the RBI setting the interest rate for all banks, individual banks can now vary rates according to their own funding needs and market liquidity conditions. This development is credit positive as it recognizes the difference between the RBI controlling policy rates, the rates at which it lends to and borrows from banks, and private interest rates, the rates at which the private sector lends to and borrows from banks.

Controlling policy rates is essential to the monetary policy objective of managing the growth/inflation trade-off; controlling private interest rates is not. In fact, evidence from India and elsewhere reveals that allowing the private (rather than regulatory) determination of price (of money, in this case) between private actors hastens responses to changes in demand/supply conditions and improves the efficiency of resource allocation.

Indian households mostly hold savings deposit accounts, and flexibility in setting interest rates for these accounts will allow banks to transmit monetary policy to households. Monetary policy shapes market liquidity conditions, which influences banks' rate-setting decisions. And bank interest rate changes will induce changes in household savings, investment and consumption behavior. This, in turn, will assist Indian policymakers in their protracted battle against inflation, since household decisions play a major role in determining economic activity.

Household consumption expenditure (63% of GDP) is the largest component of India's GDP. Households are also the biggest contributors to India's savings rate; their savings equal 23% of India's GDP. Although a significant portion of Indian households still remain outside the banking system, household bank deposits play an important role in the financial system. We estimate total savings deposits accounts to be about 25% of total bank deposits and are largely used by households. Bank deposits comprise around 44% of household financial assets.

Until its liberalization, the regulated rate on savings deposits was 4%, which yielded a negative real return to depositors as this year inflation hovered in the 8%-9% range and consensus forecasts are that it will remain above 4% through 2012.

Meanwhile, the RBI tightened monetary policy in response to high inflation, raising the repurchase rate to 8.5% from 6% 12 months ago. However, the regulated savings rate was held at 3.5% from 2003 to May 2010, when it was revised up to 4% as the regulator apparently favored long-term rate stability for depositors and was cautious about revising a rate that applied to banks of varying sizes and funding requirements. This caution in changing the rate, however, diluted the effect that changes in monetary policy rates would have had on household savings, investment and consumption behavior.

When interest rates were set by fiat and were lower than what the market would have determined, they offered de facto regulatory protection for banks, which paid a lower cost of funds. But depositors received interest rates on their savings that were lower than the cost of funds. Conversely, if regulatory interest rates were set higher than what the market would have determined, they would protect depositors at the expense of banks.

With the new regulation allowing flexible rates, as savings rates rise and fall in conjunction with market liquidity and monetary policy actions, policy will have a greater influence on savings/consumption behavior than it did through the old mechanism of a regulated interest rate that changed more slowly than market conditions.

Sub-Sovereigns

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Liquidation of Holding Communal Is Credit Negative for Belgian Regional Governments

On 22 October, the Holding Communal (HC), which was funded by Belgian municipalities and is one of the main shareholders of Dexia Group, announced its future liquidation, implying losses for regional governments in Belgium. This is credit negative for Community of Flanders, Walloon Region, and Brussels-Capital Region as it entails a net loss of about €570 million for this year.

In June, the three Belgian regional governments granted financial guarantees of a maximum of €450 million on a loan by Dexia Bank Belgium (DBB), an operating subsidiary of Dexia Group, to the HC. Earlier this month, Dexia Group announced its dismantling, as illustrated by the takeover by the Belgian government of DBB in a €4 billion nationalisation. Following the announcement, the value of shares held by the HC in Dexia Group plummeted, leading to a sharp loss in the value of HC's assets and eventually to the announcement of its future dissolution.

The 22 October agreement on an orderly liquidation foresees calls on the guarantees granted by the regions to the HC, leading to net losses of €225 million for the Community of Flanders (Aaa review for downgrade), or 1% of the region's operating revenue in 2010; €157.5 million for the Walloon Region (Aa2 review for downgrade), or around 3% of the region's revenue; and €67.5 million for the Brussels-Capital Region (unrated), or about 3% of its revenue. In addition, €120 million of the HC's commercial paper, bought in equal part by the three regional governments (€40 million each), will not be repaid, leading to further losses.

Consequently, we expect the total cost of the HC's dissolution for the regional governments to reach €570 million. This is credit negative for the regional governments as it adds further pressure on their finances during their fiscal consolidation efforts and lower-than-expected GDP growth for the country as a whole.

Although Flanders had already forecast a loss following the €40 million purchase of the HC's commercial paper, it will now have to absorb a €225 million settlement by the end of the year. However, Flanders' better-than-expected financial performance throughout the year will mitigate the impact on its finances as the region continues to predict a near-balanced budget position at year-end (i.e. no debt increase from 2010's debt level). This is all the more remarkable when compared with its national peers, which do not forecast balanced budgets before 2014-15.

The Walloon region will experience the most severe effects of the HC's liquidation. The Walloon region currently has substantially higher debt metrics than its peers (net direct and indirect debt at around 190% of its revenue at year-end 2010, compared with 80% for Flanders) and will need to implement significant cost-cutting measures to return to a balanced budget position by 2015.

Should the bill for Dexia Group's dismantling increase further for the regional governments (e.g., if the regions have to assist cities, the shareholders of the HC, following its liquidation), it will exert greater pressure on the regions' credit profile.

US Public Finance

Proposed Federal Student Loan Relief Is Credit Positive for US Colleges and Universities

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Last Tuesday, the Obama administration proposed a student loan relief plan as part of a "Pay as You Earn" plan intended to reduce the financial burden of federal student loan repayments for certain eligible borrowers. The president's proposal is credit positive for the US higher education sector because it reduces the burden of debt repayment for affected students, supporting tuition revenue. It also reinforces broader federal government tax and spending policies favoring higher education, which have the combined effect of stimulating student demand and revenue growth for colleges and universities.

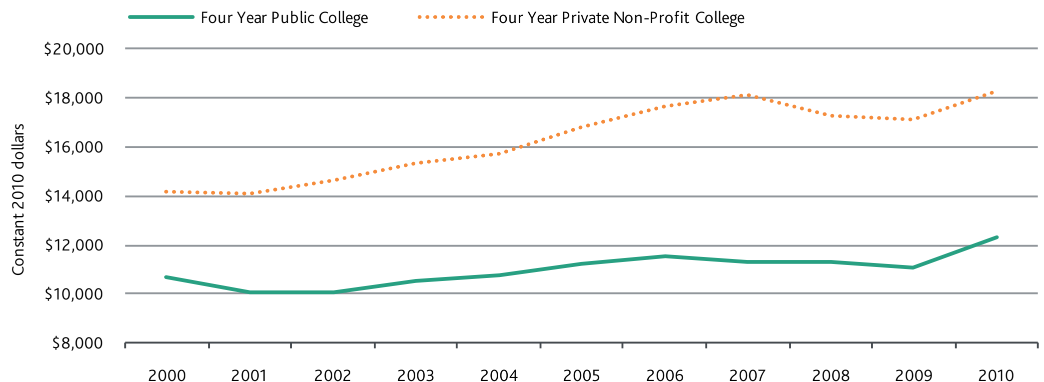
The president's student loan proposal has various components for certain eligible college students and graduates. These include potentially lower interest rates for students choosing to consolidate multiple federal student loans and an earlier reduction of maximum payment on federal student loans as a percentage of one's discretionary income. This percentage, currently capped at 15% of discretionary income, is set to decline to 10% in 2014.

Last Tuesday, President Obama proposed that the 10% cap begin in January 2012 and that the balance of federal student loan debt be forgiven after 20 years. These benefits would become available to certain students who qualify for this income-based repayment plan, with eligibility based on factors including income, family size, and state of residence.

Overall, student demand for US higher education has remained robust even during the recession. However, tuition price sensitivity has increased over the past few years owing to stock market volatility, high unemployment, and depressed family net worth caused by falling home values. Demand has shifted toward cheaper public universities as students are less confident in borrowing for higher priced colleges. The proposed action to mitigate the effect of student debt, coupled with other federal actions such as increased Pell grant awards and certain personal tax incentives, improve college affordability and encourage college attendance.

The president's proposal comes amid heightened public concern about the growth of total student debt and the pace of stated tuition ("sticker price") increases at both public and private US colleges and universities. Exhibit 1 shows the growth of average debt per bachelor's degree recipient at private and public colleges and universities over the past 10 years.

EXHIBIT 1
Average Debt of Bachelor's Degree Recipients



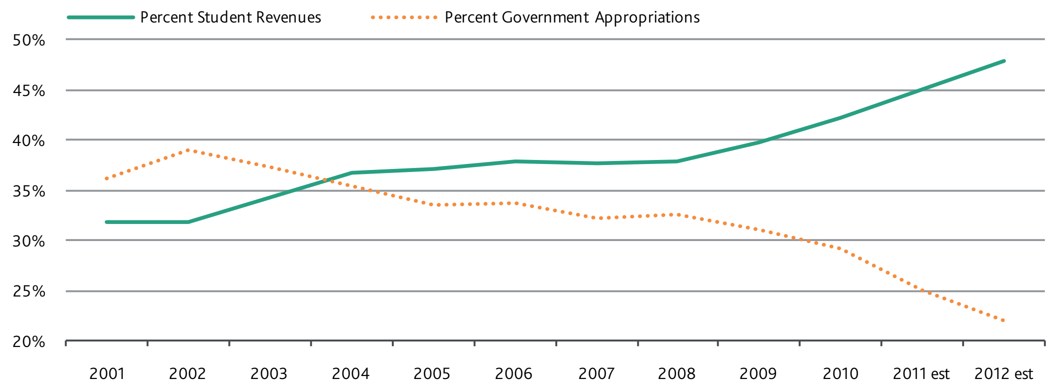
Source: Trends in Student Aid 2011, College Board

As states grapple with their own budget challenges and cut operating and capital support to public higher education institutions, growth of student-paid revenues (tuition, fees, room and board) have helped compensate, as highlighted in Exhibit 2. Although most colleges and universities are improving operating efficiency and expense containment, a college's ability to increase net tuition remains a critical credit risk factor for the sector. The Obama administration's proposal to increase federal student loan relief would, on the margin, mitigate some of this credit risk, especially considering that the financial burden of higher education, particularly at public colleges and universities, is increasingly shifting to families.

EXHIBIT 2

Public University Funding Burden Shifts to Students

Median Share of Revenues by Source



Source: Moody's

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Servicing Transfer at Access Group Is Credit Negative for its Private Student Loan ABS

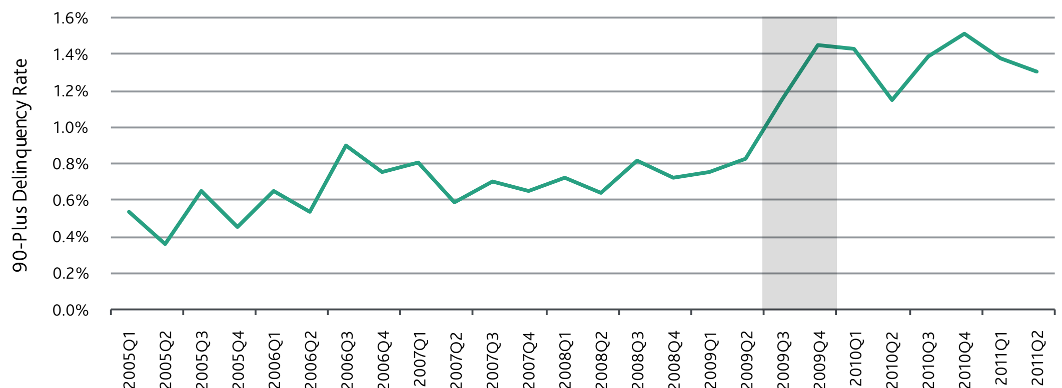
On 28 October, Access Group Inc., a sponsor, administrator, and primary servicer of student loan securitizations, confirmed that it intends to stop servicing its existing FFELP and non-guaranteed (private) student loan portfolio and will transfer servicing to a third party. For Access Group's $2.3 billion private student loans, a transfer is credit negative because it raises the risks of delinquencies and defaults, lower recoveries, and ultimately increased losses on the securitized pool. In addition, a weaker alignment of incentives for the replacement servicer reduces its incentive to collect rigorously. A transfer also gives rise to the possibility that the replacement servicer has less experience and expertise in private student loan collections than Access Group. For Access Group's $5.1 billion FFELP student loan portfolio, the transfer does not increase risk significantly.

Volatility in collections likely. A servicing transfer is credit negative for Access Group's private student loan securitizations because it increases the risks of delinquencies and defaults, lower recoveries, and ultimately higher losses on the securitized pool.

For example, Access Group's takeover of servicing on its managed student loan portfolio from Kentucky Higher Education Student Loan Corporation (KHESLC) in mid-2009 caused performance deterioration. A short-term spike in delinquencies occurred throughout the transfer. From first-quarter 2005 until second-quarter 2009, the average 90-plus delinquency rate for Access Group's private student loan securitizations was relatively stable, ranging from roughly 0.6% to 0.8%. However, the rate increased sharply to 1.5% in fourth-quarter 2009, as shown in the exhibit below. While the weak economy and high unemployment contributed to the overall increase in delinquencies, the sudden spike likely resulted from the transfer. During servicing transfers, customer outreach can suffer as the replacement servicer adds the new accounts into its systems. In addition, borrowers are sometimes not aware of where to send payments, resulting in payment to the wrong servicer or a missed payment.

Access Group Private Student Loan Securitizations

90-Plus Day Delinquencies Over Active Repayment



*Active repayment balance is equal to the pool balance less the balance of loans in in-school, grace, deferment and forbearance status.

Source: Moody's Private Student Loan Indices

If replacement servicer has less stringent servicing standards, risk rises. Loan performance can deteriorate after the transfer if the quality of servicing provided by the replacement servicer is weaker than that of Access Group. The ability of the new servicer to prevent and cure borrower defaults and the steps a servicer takes to minimize losses if a borrower does default are critical to the ultimate performance of the securitizations.

Going forward, alignment of incentives will be less. A replacement servicer will not have a residual interest in the transaction, and therefore will not have the incentive that Access Group currently has to collect vigorously. Access Group is the owner of the residuals of their securitizations, which aligns its incentives to collect vigorously with the interests of investors.

Transfer affects private student loans more than FFELP loans. The risks of the transfer are higher for Access Group's private student loan portfolio than for their FFELP portfolio. For Access Group's FFELP student loan portfolio, the transfer does not increase risk significantly because FFELP loans have undergone numerous successful transfers and because the standardized servicing platforms for FFELP loans makes them easily transferable. They are also not as vulnerable as private loans to servicing risk because the US government insures 97% of the loan amount.

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Massachusetts Foreclosure Case Exposes RMBS Trusts to Additional Losses

On 18 October, Massachusetts' highest court ruled in *Bevilacqua v. Rodriguez* that a purchaser of a property on which a residential mortgage-backed securities (RMBS) servicer improperly foreclosed cannot take advantage of a legal remedy called a "try title" action to clear his title. This ruling exposes RMBS servicers and trusts to the cost of re-foreclosing and damage claims from purchasers of foreclosed properties and ousted borrowers. If servicers pass costs and damages to the trusts, investors will suffer higher losses.

Massachusetts foreclosure flaws create tainted titles. *Bevilacqua* is an outgrowth of the January 2011 *US Bank v. Ibanez* ruling by the same court, in which the court ruled that under Massachusetts law a foreclosing party must possess written proof that it owns the mortgage prior to commencing the foreclosure.[30] Prior to that ruling, it was common practice among RMBS servicers to commence a foreclosure first and only afterwards receive a written assignment of mortgage naming the RMBS trust as mortgage holder. The *Ibanez* case clarified that titles were tainted in these cases.

The *Bevilacqua* court held that a purchaser of an improperly foreclosed property could not use a Massachusetts legal remedy called a try title action to clear his title. In the case, the plaintiff purchased a foreclosed property from an RMBS trust in 2006. The servicer of the RMBS trust had commenced the foreclosure without having the assignment of mortgage in hand. Years later, the plaintiff brought the try title action to clear his title after the *Ibanez* decision ruled that such foreclosures were invalid.

Without the ability to bring a try title action, the most practicable way to clear a title is for the servicer to re-foreclose in order to extinguish the borrower's rights to the property. Re-foreclosure would be an additional servicing cost. Other ways to clear title might include the mortgage holder using the Massachusetts' "foreclosure-by-entry" process by possessing the property for three consecutive years and then transferring title to the purchaser, or the purchaser obtaining a release from the ousted borrower and all lienholders of record.[31]

Many tainted titles outstanding. The *Ibanez* and *Bevilacqua* decisions leave many Massachusetts properties with tainted titles and no easy remedy to clear them. For post-2005 vintage, first-lien private-label RMBS we rated, approximately 31,500 Massachusetts loans went through or were in the middle of the foreclosure process as of January 2011, when the high court decided *Ibanez*. Third-party purchasers now own approximately 70% of the properties that had backed these loans.

Servicers and trusts face potential costs and damage claims. Servicers and trusts will bear the costs of re-foreclosing and face potential claims resulting from the flawed foreclosures and tainted titles. RMBS trusts will suffer if servicers argue that they do not have to bear the costs and damages resulting from the faulty foreclosure and title remediation and instead pass them onto the trusts. Many RMBS pooling and servicing agreements require the servicer to bear responsibility for its negligence. However, the possible counter argument by a servicer is that *Ibanez* was a surprising decision and that prior to it the servicer was acting reasonably by following the market practice for conducting foreclosures.

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[30] See Massachusetts Foreclosure Case Upholds Securitization Principles, but Court Insists that Trusts Prove Ownership, 17 January 2011.
[31] See *Bevilacqua,* Amicus Curiae brief of the Massachusetts Attorney General.

RATING CHANGES

Significant rating actions taken the week ending 28 October 2011

Corporates

Amgen Inc.

	28 Apr 11	Outlook Change 25 Oct 11
Senior Unsecured Rating	A3	A3
Short-Term Issuer Rating	P-1	P-1
Outlook	Stable	Negative

The revision in the outlook to negative stems from Amgen's new $10 billion share repurchase authorization and Amgen's stated intention to accelerate repurchases. Although the exact timing and funding of repurchases has not been determined, there is a possibility Amgen's key credit metrics will fall outside the ranges currently assumed in the A3 rating. The affirmation of Amgen's A3 ratings reflects its strong position as the world's largest standalone biotechnology company, its high margins and its good cash flow.

Peugeot S.A.

	11 Feb 11	Outlook Change 26 Oct 11
Long-Term Issuer Rating	Baa3	Baa3
Short-Term Issuer Rating	P-3	P-3
Outlook	Stable	Negative

The negative outlook was triggered by Peugeot's announcement that it has revised downwards – for the second time this year – its expectations for the operating performance of its Automobile division. This has caused weaker performance of its total Industrial operations, which contrary to our expectations of further improvements in profitability and credit metrics that were incorporated in the rating earlier in the year. The Baa3 rating continues to be supported by the group's sound competitive position, evidenced by its leading position in the European light vehicle market ranking behind market leader Volkswagen.

United States Steel Corporation

	27 Apr 09	Downgrade 24 Oct 11
Corporate Family Rating	Ba2	Ba3
Outlook	Negative	Stable

The downgrade to a Ba3 CFR reflects the fact that the company's return to metrics appropriate for a Ba2 corporate family rating has been more protracted than anticipated, reflected by a LTM Debt/EBITDA ratio of 6.4x at 30 June 2011 and an EBIT/interest ratio of less than 1x. The downgrade also considers that while year-on-year performance is improving, the time horizon to stronger metrics will be slow and erratic given the challenges facing the steel industry. Only a gradual improvement is therefore likely in debt-service protection metrics and cash flow generation over the next 12 to 24 months.

RATING CHANGES

Significant rating actions taken the week ending 28 October 2011

Kirin Holdings Co., Ltd.

	2 Aug 11	Downgrade 24 Oct 11
Long-Term Issuer Rating	A2	A3
Outlook	Review for Downgrade	Negative

The downgrade reflects our view that Kirin's acquisition of 50.45% of the shares in Schincariol Participações e Representações S.A. (Schincariol; unrated) has weakened Kirin's credit profile because of the need for debt financing. Kirin's entry into Brazil, where it has limited expertise, has increased its business risk. The negative outlook captures (i) Kirin's challenges in integrating the operation in Brazil; (ii) the possibility of an increase in financial burden, in order to execute a smooth integration; and (iii) the pending litigation risk surrounding the acquisition.

Ford Motor Company

	5 Oct 11	Upgrade 27 Oct 11
Corporate Family Rating	Ba2	Ba1
Outlook	Review for Upgrade	Positive

The upgrade reflects the company's strong position in North America, its ability to maintain a competitive and flexible cost structure as a result of the new four-year labor agreement, and the resulting improvement in credit metrics. The rating also considered the ongoing challenges associated with successfully executing its global operating strategy. The ratings also recognize the risks of a double dip downturn in the US economy, and the potential fallout from the European financial crisis.

Sony Corporation

	18 Oct 11	Review for Downgrade 28 Oct 11
Long-Term Issuer Rating	A3	A3
Short-Term Issuer Rating	P-2	P-2
Outlook	Negative	Review for Downgrade

This action has been prompted by Sony's announcement on 27 October 2011 that it will acquire Telefonaktiebolaget LM Ericsson's (A3 stable) 50% stake in Sony Ericsson Mobile Communications AB (unrated). As a result, Sony Ericsson will become a wholly-owned subsidiary of Sony. We are concerned that this transaction is likely to further delay improvements in Sony's financial metrics, including leverage, due to the cost of the acquisition and slower-than-anticipated improvements in cash flow as Sony works to improve results at Sony Ericsson Mobile Communications AB.

Significant rating actions taken the week ending 28 October 2011

Wyndham Worldwide Corporation

	15 Sep 10	Upgrade 28 Oct 11
Senior Unsecured Rating	Ba1	Baa3
Outlook	Positive	Stable

The upgrade reflects a modest improvement in credit metrics in 2011, and our expectations that revenues, earnings, and normalized free cash flow will increase again in 2012. The upgrade also reflects a very good liquidity profile that in our view will enable Wyndham to better manage through periods of market and economic volatility.

Hewlett-Packard Company

	19 Aug 11	Review for Downgrade 28 Oct 11
Long-Term Issuer Rating	A2	A2
Short-Term Issuer Rating	P-1	P-1
Outlook	Negative	Review for Downgrade

The review for downgrade follows the completion of the company's strategic review surrounding its personal computer business. While HP completed a major strategic decision to keep the PC business, we will focus on HP's unfolding corporate strategy under HP's new CEO, as well as the capital structure and liquidity profile implications. The review will also focus on management's plans and the investment requirements to reinvigorate the growth and higher value focus of the company's $35 billion services business while it also seeks to reposition HP's broad portfolio into higher margin areas.

Financial Institutions

Banco de Valencia (Spain)

	06 Jul 11	Downgrade 28 Oct 11
Long Term Senior Debt & Deposits	Ba1	Ba2 Review for Downgrade
Subordinated Debt	Ba2	Ba3 Review for Downgrade
Standalone Bank Financial Strength/Mapping to Long-term Scale/Outlook	D-/Ba3	D-/Ba3/ Review for Downgrade
Short-Term Ratings	NP	NP

The downgrade follows the new majority ownership of Banco de Valencia by Banco Financiero y de Ahorro (BFA, Ba2/ negative outlook); and the review assesses the degree of ongoing support from either BFA or Bankia, BFA's operating company. Banco de Valencia is currently working on a recapitalization plan that will be implemented before year-end 2011. The plan will include some measures that will require support from Bankia to implement successfully.

RATING CHANGES

Significant rating actions taken the week ending 28 October 2011

PrivatBank AS (Latvia)

		Review for Downgrade
	12 Dec 08	**25 Oct 11**
Long Term Local & Foreign Currency Deposit Ratings	B2	B2 Review for Downgrade
Standalone Bank Financial Strength/Mapping to Long-term Scale	E+/B3	E+/B3 Review for Downgrade

The review for downgrade reflects the concerns we have after the bank failed to raise a planned LVL66 million of capital in 2011, further losses in the first half of the year that led to further capital depletion, and deteriorating asset quality with problem loans increasing to 52% of gross loans. The capital raising was originally announced in March 2011 as address to regulatory concerns over one of the bank's larger shareholders, Unimain Holdings.

BancorpSouth Inc.

		Downgrade
	05 Aug 10	**24 Oct 11**
Long Term Deposit & Debt Ratings	Baa1	Baa2
Outlook	Stable	Negative

BancorpSouth Bank

		Downgrade
	05 Aug 10	**24 Oct 11**
Long Term Debt & Deposit Ratings	A3	Baa1
Standalone Bank Financial Strength/Mapping to Long-term Scale	C/A3	C-/Baa1

Deterioration in asset quality drove the downgrade in the ratings of BancorpSouth Inc. and its lead bank, BancorpSouth Bank. We are also concerned about potentially a further deterioration in asset quality as the total amount of special mention and substandard loans increased 27% in the last quarter. These credit indicators are in marked contrast with those of many of BancorpSouth's peers, which have experienced either stable or improving trends in their credit metrics in recent quarters.

MF Global

		Downgrade
	06 Nov 09	**24 Oct 11**
Long Term Debt & Deposit Ratings	Baa2	Baa3 Review for Downgrade

The rating action reflects our view that the current low interest environment and volatile capital markets conditions make it unlikely that MF Global, in the near term, will be able to achieve the financial targets that we had specified for maintaining its Baa2 rating. These included generating $200-$300 million in annual pre-tax earnings and managing its balance sheet leverage in the 20x range, a level that would be consistent with similarly rated broker-dealer peers. We are also becoming increasingly concerned with MF Global's risk management and management's ability to prudently balance risk and reward as it undergoes a substantial re-engineering of the firm.

RATING CHANGES

Significant rating actions taken the week ending 28 October 2011

MF Global

	24 Oct 11	Downgrade 27 Oct 11
Long Term Debt & Deposit Ratings	Baa3 Review for Downgrade	Ba2 Review for Downgrade

The further downgrade reflects our view that MF Global's weak core profitability contributed to it taking on substantial risk in the form of its exposure to European sovereign debt in peripheral countries. At the end of the second quarter, MF Global's $6.3 billion sovereign risk exposure represented five times the company's tangible common equity.

Sovereigns

Egypt

	16 Mar 11	Downgrade 27 Oct 11
Gov Currency Rating	Ba3	B1
Foreign Currency Deposit Ceiling	B1	B2
Foreign Currency Bond Ceiling	Ba1	Ba2
Local Currency Deposit Ceiling	Baa3	Ba1
Local Currency Bond Ceiling	Baa3	Ba1
Outlook	Negative	Negative

The primary driver of the downgrade is the ongoing economic weakness and financial deterioration, which has deepened further since the onset of the country's popular revolution in January 2011. We are concerned that the external and fiscal positions may remain particularly fragile. Unsettled political conditions have further undermined economic performance and investor confidence in Egypt. The economy is struggling to find its footing.

Sub-Sovereigns

State of Chihuahua (Mexico)

		Downgrade
	20 Sept 05	**26 Oct 11**
Issuer Rating	Baa3/Aa3.mx	Ba1/A1.mx
Outlook	Stable	Stable

The downgrade was driven by Chihuahua's weak financial performance. The state has recorded continuous modest cash financing requirements that have led to increases in debt over the past five years. We expect cash financing requirements will increase in 2011 driven by the operating (mainly education and public security) and capital spending pressures in conjunction with the slowdown of revenue growth due to the deceleration of the Mexican economy and the absence of a state tax that substitutes the federal vehicle registry tax.

Municipality of Monterrey (Mexico)

		Downgrade
	22 Jul 05	**24 Oct 11**
Issuer Rating	Ba1/A1.mx	Ba2/A2.mx
Outlook	Stable	Stable

The downgrade reflects the rapid decline of operating balances coupled by increases in already high debt levels to fund investments. While the measures implemented by the municipality to increase own-source revenues are bearing fruit so far during 2011, operating expenditures have increased at a faster pace. Therefore, reverting the decline in operating margins remain one of the main challenges for Monterrey. Moreover, the city recently issued more debt, driving debt to total operating revenue to a very high level.

US Public Finance

San Diego (California) Unified School District

		Downgrade
	28 Jul 10	**27 Oct 11**
General Obligation Rating	Aa1	Aa2
Outlook	Negative	Negative

The one-notch downgrade primarily reflects the district's substantially narrowed financial flexibility after material draws on reserves in recent years. The still high rating continues to be based in large part on the district's sizable, diverse tax base as well as its uncomplicated and manageable debt portfolio, although its structure is somewhat weak. The negative outlook on the rating reflects the district's practice of funding ongoing expenditures with one time sources, which is a distinct credit risk given the potential for mid-year funding cuts in the current year and continued tight funding going forward.

RATING CHANGES

Significant rating actions taken the week ending 28 October 2011

Structured Finance

US Auto loan ABS Continues To See Positive Rating Actions

Because of lower loss expectations and build-up in credit enhancement we:

- upgraded seven tranches in six transactions issued by CPS, HELIOS, Triad and Wachovia. Ratings improved between one and three notches, with five of the seven tranches now rated Aaa(sf)
- placed on review for upgrade two subordinate tranches in a 2011 Hyundai auto loan transaction

Upgrades To CLOs Continue

We continue to upgrade CLOs because of our recent methodology change, improvements in performance, or deleveraging. We upgraded the ratings on 105 tranches in 24 CLO transactions between one and eight notches. To date, we have completed 152 deals or 88% of the European deals, and 549 deals or 91% of the US deals under review for upgrade.

Corporates

China Property: Liquidity Risks For Most Rated Chinese Developers Are Manageable In The Next 12 Months

Most of the Chinese property developers that we rate are well-positioned against the near-term challenges posed by ongoing funding constraints and slowing sales. These rated developers are listed in Hong Kong, and tend to have better access to bank funds than their smaller counterparts. And many rated developers have maintained access to offshore funding through equity and bond issuances. Our analysis shows that most of the rated developers demonstrate robust liquidity profiles, even under conservative assumptions, mostly due to sizable cash on hand.

Ford, GM Labor Contracts Maintain Competitive Standing

We consider that the new four-year labor agreements with the United Auto Workers Union (UAW) maintain the highly competitive positions of Ford Motor Co. and General Motors Co. (both Ba2, review for upgrade) in the North American automotive market. The pacts preserve the companies' current operating models, which are generating strong profits and cash flow in North America. They are also gaining greater flexibility to respond to economic downturns. Ratification of the contracts removes one key hurdle to potential rating improvement for Ford and GM.

Indonesian Coal Miners: Stable Amid Uncertain Global Macro Outlook

The outlook for the Indonesian coal industry is stable, despite a rising level of global macroeconomic risk. The sector's strengths – including strong financial profiles – outweigh weaknesses and possible risks, such as the uncertainty surrounding the global economy. Overall, ratings for companies in the sector should remain resilient. Specifically, a strong pipeline of thermal-coal power projects around the region will support thermal-coal prices, while coal issuers' low-cost base, ties with utilities in Asia Pacific, strong liquidity, and improved debt-maturity profiles support their ratings.

US Retail Industry: Downbeat Consumer And Fragile Economy Will Restrict Earnings Growth In 2012

The US retail industry will perform in line with sluggish US GDP growth throughout 2012, as persistent unemployment, stock market volatility and economic gloom exert pressure on consumer confidence and spending. The outlook for the sector is stable, with real operating-income likely to stay flat or rise only 1% in 2011, and increase a mere 2-3% in 2012. Although consumers face headwinds, retailers remain challenged by increased commodity prices.

Lend Lease Group, Army Hawaii Family Housing LLC, Atlantic Marine Corps Communities LLC

Lend Lease, a developer/manager of approximately 40,000 privatized military housing units in the US, launched a special initiative on 12 October, to retrofit its units with energy efficiency upgrades. This initiative is credit positive for privatized military housing bond financings secured by revenue from these projects. The reduction and greater control over utility expenses – which are often a major source of operating cost burden and volatility – will bolster their financial performance.

Limited Impact On Bumi Resources And Berau Coal From Bakrie & Brothers' Troubles

Concerns have been rising over the impact of Bakrie & Brothers's (BNBR) debt troubles on the credit profiles of Bumi Resources and Berau Coal Energy (BCE). However, there are limited credit implications for Bumi Resources and BCE. In Bumi and BCE's debt indentures, strong covenants and cash-distribution agreements that prioritize debt servicing and limit shareholder-friendly actions provide protection to bondholders and bank creditors. In addition, a material dilution of BNBR's interest in Bumi Plc is unlikely and the Bakrie family group has strong incentives to retain their stake in Bumi Plc, the group's prized asset.

Upstream Asset Acquisitions: Short-Term Pain, Long-Term Gain

The outlook for Asia Pacific's exploration and production (E&P) industry is positive, in line with our current global E&P industry outlook, which we changed to positive from stable in an earlier outlook update of April 2011. The positive outlook reflects: (i) Asian E&P firms' increasing pace of acquisitions poses risks; (ii) E&P firms from Asia are increasing their unconventional energy reserves; (iii) rise in earnings driven by robust demand from China and India; and (iv) Margins should remain high.

Asia-Pacific Oil-And-Gas Industry – Refining & Marketing: Rising Capex, Slowing Demand Constrain Credit Profiles

The outlook for the Asia-Pacific refining and marketing industry is stable, in line with our global R&M industry outlook. The outlook reflects: (i) ongoing capex holds back ratings, but financial metrics have sufficient headroom; (ii) the R&M sector has reached a peak in its business cycle; (iii) structural overhang in refining capacity will persist; (iv) focus of high capex share on diversification and vertical integration is positive; and (v) strong access to capital markets helps balance-sheet liquidity.

Infrastructure

Wider Rating Differentials Seen For A Number Of US Utility & Parent Companies

In a review of a large number of utility holding companies, we have noted a wider-than-expected difference between the credit ratings of parent companies and their US utility subsidiaries for a meaningful number of companies, the cause of which is primarily laid to parent company debt. More instances of wider 'notching' differences between parent and subsidiary is noteworthy because most parent holding companies tend to manage their utility subsidiaries as a system, so the ratings range should be narrow. The ratings for most parent holding companies are one notch below their largest regulated operating subsidiary or subsidiaries, reflecting structural subordination.

Financial Institutions

Banking System Outlook: Russia

We have changed our outlook for the Russian banking system to negative from stable to reflect our concerns that the deteriorating global economic landscape and financial market volatility will weaken the banks' operating environment, with system-wide liquidity contraction, slower credit growth and pressured asset quality.

Banking System Outlook: Bahrain

Our outlook for the Bahraini banking system remains negative, reflecting the more challenging operating environment following political unrest earlier this year. While order has been restored, the events disrupted parts of the Bahraini economy and weakened the country's profile as a regional banking hub, in turn weighing on banks' asset quality, growth and profitability.

2Q 2011 Quarterly Update – Asset Managers

Asset managers' second-quarter results were a harbinger of third-quarter activity. Investors became even more conservative in the face of disappointing results and increased market volatility. We expect that revenue growth will stall or even decline for many managers and that controlling expenses will be critical to supporting EBITDA in current market conditions.

Money Market Funds: Decline Of Eligible Assets Raises Challenges

Prime money market fund managers have seen consistent declines in their short-dated, high-quality eligible investments following, on the supply side, a decline in product availability, reduced short-dated issuance from key sectors and regional liquidity pressures, while on the demand side they face more stringent regulatory requirements, limiting their investment flexibility.

Sovereigns

Credit Analysis: Paraguay

Paraguay's rating continues to show upward momentum thanks to a strong economic track record and favorable fiscal and debt dynamics. However, its large agricultural component and reliance on soft commodity exports leave it vulnerable to exogenous shocks. While there is a broad political consensus in favor of an orthodox fiscal and monetary policy mix, Paraguay still ranks severely behind many of its B rated peers in terms of government effectiveness and control of corruption as evidenced by poor public project implementation and a large informal sector.

Structured Finance

Relaxed Underwriting Standards Are Credit Negative For Russian RMBS Collateral Performance

Looser underwriting standards have partly driven the renewed rapid expansion of the Russian mortgage market, with mortgage lenders offering higher loan-to-value ratio (LTV) loans at lower interest rates. In some cases, we believe that originators have not made sufficiently robust credit checks on the relevant borrowers. We consider that the return to looser underwriting—so soon after the first wave of the crisis in 2008-2009—to be credit negative for RMBS performance in Russia, as delinquencies and defaults will inevitably rise

Credit Card Statement Newsletter

Despite its record-high purchase rate, Amex's trust balance has not been growing. We explore how its cardholders are paying back their purchases, and how small changes in the difference between the payment rate and the purchase rate can lead to significant changes in a trust's balance. Also discussed: credit card charge-off rates continue to fall, Citi changes its mind about retail-branded cards, card delinquencies signal the end of Big Six reserve releases, the new debit card fees, accelerating retail sales belie low consumer confidence.

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