6 November 2009

Weekly Credit Update

Summary

- CDS indices remain range bound
- CIT files for chapter 11
- RBS forced to sell off assets
- Lloyds announces debt exchange offer and rights issue

Headlines from the credit market this week

Banks are back in the headlines following CIT's filing for chapter 11 as well as the restructuring plans by RBS and Lloyds (more on all three topics below). Nonetheless, both the senior financial CDS index as well as iTraxx Europe remain largely unchanged from last week. Currently, iTraxx Europe and Crossover trade at 87bp and 530bp, respectively.

We continue to see some activity in the primary market. Nordea came to the market with two USD tranches totalling USD2.0bn. The levels were 120bp and 140bp to the US Treasury curve, which is a relatively wide level taking into account the US and EUR basis swap and the levels of outstanding Nordea EUR senior bonds. Apart from this, TeliaSonera came to the market with a 12-year bond at 105bp to mid-swaps.

Table 1. Selected new issues during the week

Name	Rating	Coupon	Maturity	Currency	Size	Bond spread on issue date, (bp)*
Linde	Baa1/BBB+	Fixed	5Y	USD	0.4bn	Gov +128
TeliaSonera	A3/A-	Fixed	12Y	EUR	0.6bn	105
Nordea Bank	Aa2/AA-	Fixed	3 & 5Y	USD	2.0bn	Gov +120&140
Norwegian Cruise	B3/B+	Fixed	7Y	USD	0.45bn	Gov +892

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

Source: Danske Markets & Bloomberg

CIT files for chapter 11

During the weekend US lender CIT Group filed for chapter 11, thereby seeking protection from its creditors. This move was largely expected since CIT has been in severe difficulties for some time following large losses. The bank will continue but existing shareholders will probably be wiped out whereas senior bondholders are likely to receive 70% of face value in a debt exchange that will also recapitalise the company. For bondholders, we consider this to be a pretty good outcome considering the recovery rates we have generally seen in bank defaults. CIT had total assets of USD71bn by the end of the third quarter this year and thereby the default ranks as the fifth largest in the US in terms of assets. CIT is an SME lender that was largely wholesale funded.

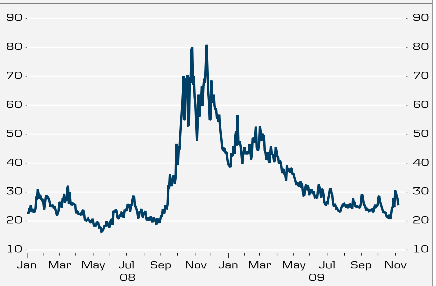
iTraxx Europe (5Y CDS)

Source: Markit

iTraxx Crossover (Y CDS)

Source: Markit

VIX volatility index



Source: Ecowin Pro

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RBS agrees terms of UK asset protection scheme (APS)

The UK authorities and RBS have agreed on changing the terms of the APS in order to better align it to the current needs of RBS. The amendment implies that RBS will commit to a larger first-loss piece and furthermore the pricing structure has been changed to better reflect current market conditions (the general appreciation of prices of risky assets). The re-priced scheme is designed such that RBS absorbs all of the expected losses in a base-case economic scenario and only calls upon the assistance of the UK government in the event of a substantial further deepening of the recession.

At the same time, RBS announced a restructuring plan which – in principle – has been agreed with the European Commission. This plan can be compared to what was announced last week by ING and is a consequence of the significant name-specific state aid (in the form of capital injections) that RBS has received during the financial crisis. The restructuring plan will be invoked over four years and involves the following measures: RBS must divest some of the RBS branch network in England and Wales and the NatWest branches in Scotland and Direct SME customers across the UK. Furthermore, RBS will have to divest RBS Insurance and Global Merchant Services.

In addition to this, RBS will not pay investors any dividends or coupons on existing hybrid capital instruments (including preference shares and B shares) or exercise any call rights in respect of such existing securities for a two-year period unless there is a legal obligation to do so. Thereby the effects of the burden-sharing principle continue to be felt for the banks and highlights that for subordinated debt holders it will be key to avoid exposure to banks needing state aid.

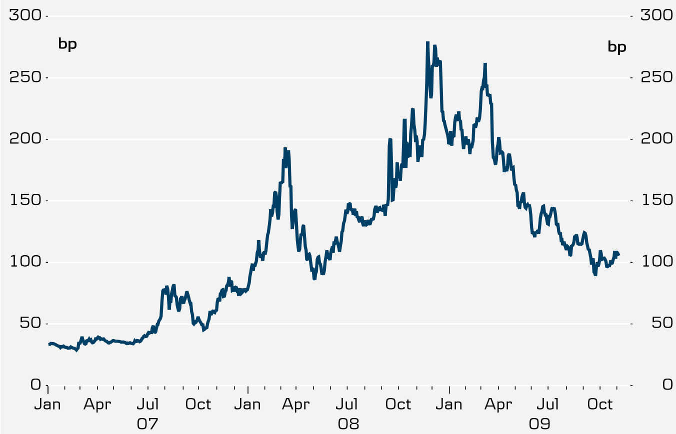
Lloyds' debt exchange offer and capital raising

At the same time as RBS announced the amendments to the APS scheme and its restructuring plans, Lloyds announced that it will seek to engage in a major rights issue. In addition, Lloyds put forward a proposal to restructure its subordinated debt. This implies that we will now have to deal with yet another subordinated asset class: convertible lower tier 2s – the official name is Enhanced Capital Notes (ECN) but in the market they are also referred to as Contingent Capital Notes 'Cocos'. In short, the advantage of the ECNs is that coupons are non-deferrable. On the other hand, the investor will be exposed to a risk of equity conversion should the Tier 1 ratio fall below 5%. The conversion price will be determined at the current share price and thus the number of shares received at conversion date will be pre-determined. As the share price of the company is likely to be materially lower if the trigger is reached (as default risk would be materially higher), any equity conversion will imply a significant loss for the holders of the ECNs (Note that if the conversion was not there, the downside risk would still be high resulting in a high implied loss anyway. Hence this feature should not necessarily cause investors to demand a substantial additional premium.)

In order to incentivise current sub debt holders to exchange their positions into ECNs, Lloyds has made it clear that it will not make discretionary payments of coupons or dividends on hybrid capital securities (other than in the insurance group). Furthermore, the company will not exercise calls until 2013.

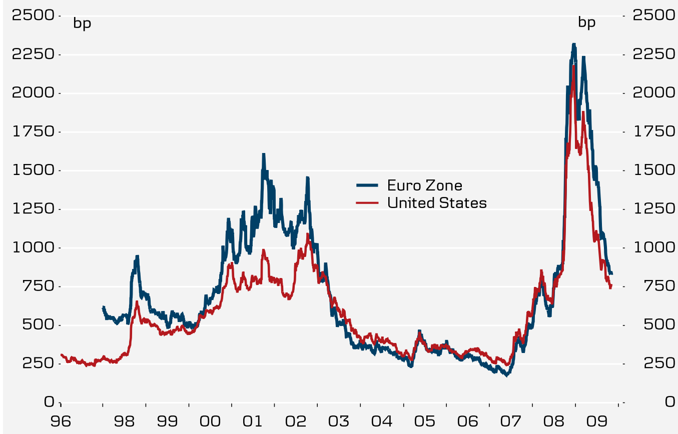
With these measures Lloyds will seek to raise at least GBP7.5bn in core tier 1 and/or nominal value of contingent core tier 1 capital through the debt exchange offer and GBP13.5bn by way of a rights issue. The proceeds are to be used to exit from the APS.

US investment grade CDS index (CDX)



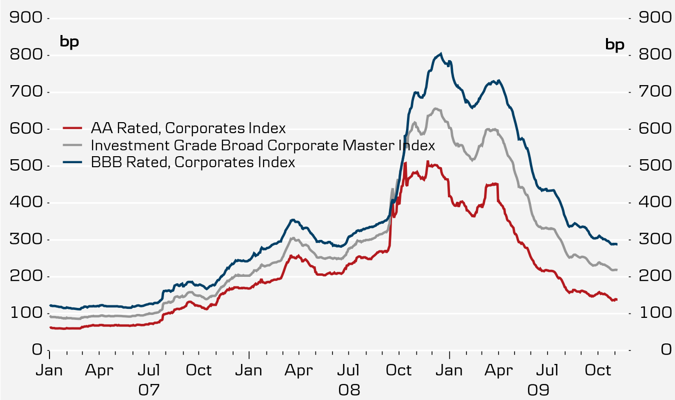
Source: Ecowin Pro

Merrill Lynch US & European high yield cash indices



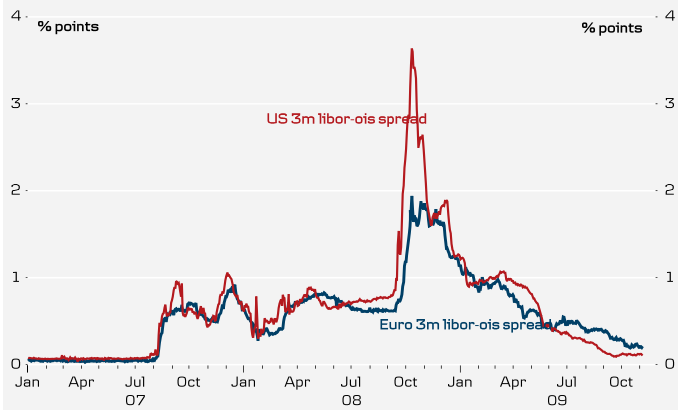
Source: Ecowin Pro

US cash indices



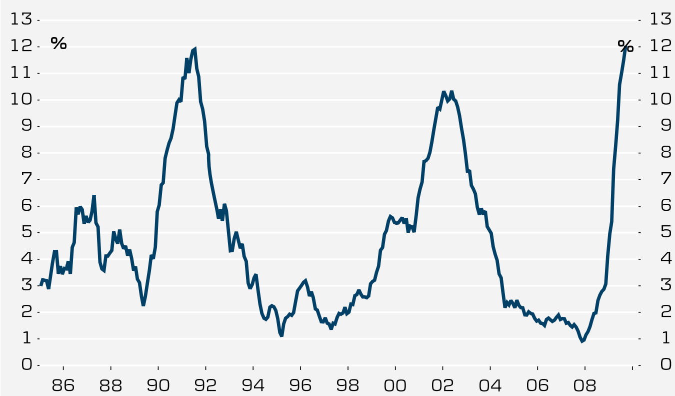
Source: Ecowin Pro

3M LIBOR-OIS spread



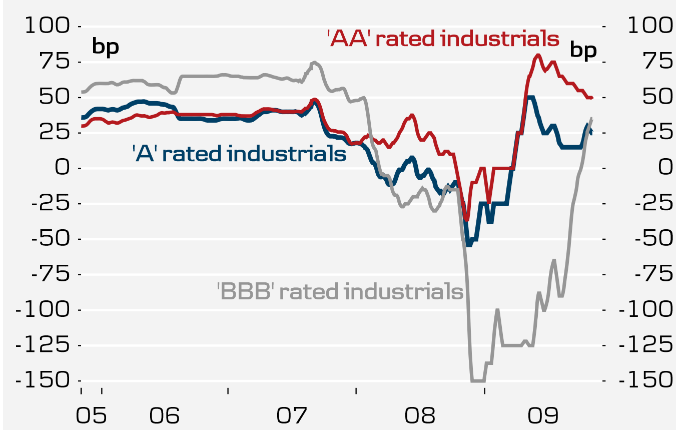
Source: Ecowin Pro

Moody's global speculative default rate (LTM)



Source: Ecowin Pro

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



Source: Ecowin Pro

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