



A POSITIVE RESOLUTION TO THE SOVEREIGN DEBT CRISIS? WE THINK SO – BUY BANKS SELECTIVELY

We believe some market participants have been too negative in concluding that the sovereign debt crisis will ultimately lead to the breakup of the Euro. We appreciate the lack of political accord among EU member countries means that a unified fiscal structure will not be on the agenda for a long time. Within the confines of a single currency, this is something we consider necessary to facilitate the free flow of tax revenues to those countries with a fiscal deficit. Should such a situation persist, *ceteris paribus*, we would share the concern that the Euro would come under massive pressure to be broken up; however, our view is that the near €1tn bailout package has bought Europe time to come up with a mechanism for the voluntary restructuring of sovereign debt. The path to such an outcome is fraught with potential volatility. However, our main point is that the financial system should be able to avert a systemic crisis with such a mechanism in place, while also avoiding a lot of the negative problems associated with a breakup of the Euro.

- We believe a breakup of the Euro would lead to severe solvency risks; there would be a technical default of peripheral European sovereign debt, and all banks which own such debt would suffer writedowns and risks to their capital adequacy. The interconnectedness of the system (with French and German banks in particular owning substantial amounts of peripheral European sovereign debt) means that the entire European banking sector would have its capital adequacy at risk.
- The lack of political agreement between member states means that a unified tax regime in Europe is clearly off the agenda for a long time. Within the confines of a single currency, this is something we consider necessary to facilitate the free flow of tax revenues to those countries with a fiscal deficit. Should such a situation persist, *ceteris paribus*, we share the fear that there would be strong pressure to break up the Euro.
- However, the near €1tn bailout package is enough, by most accounts, to fund all the fiscally weak peripheral European countries (i.e. Greece, Portugal, Spain, Ireland and Italy) to at least the end of 2011. This is valuable time. We believe this will allow a mechanism to be devised to enable the voluntary restructuring of sovereign debt, should it prove to be the case that the peripheral European countries are unable to bring their deficits under control via fiscal intervention alone.
- The voluntary participation of creditors in the restructuring process has many advantages compared with a breakup of the Euro: the terming out of maturities and reduction in interest rates makes the debt much easier to service; the voluntary nature of the process means that writedowns are avoided, so solvency risks are mitigated; and last but not least, the Euro remaining as a single currency means that the share prices of companies domiciled in the peripheral European countries are not devalued.
- Our ratings for the Pan-European lending banks remain unchanged and we are generally positive on the sector. However, we reduce target prices for the banks on which we hold a more negative view, reflecting a greater expected impact on earnings from the commitment to national fiscal cutbacks. This includes **BBVA** (rated SELL, target price reduced to €8.00 from €9.60), **Santander** (HOLD, target price to €9.50 from €11.30), **Intesa** (HOLD, target price to €2.45 from €2.60), and **Unicredit** (SELL, target price to €1.85 from €2.00). Target prices for our BUY rated stocks (**DNBNOR**, **Nordea**, **Handelsbanken**, **Lloyds** and **Standard Chartered**) remain unchanged. Our target price for **HSBC**, rated SELL, also remains unchanged. We may have been a bit premature in our negativity for HSBC, but stand by our view that in a UK context, the bank has neither the restructuring potential of Lloyds nor the growth prospects or capital strength of Standard Chartered.

Research

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EURO BREAKUP IS UNLIKELY

Breakup of the Euro Would Cause Significant Systemic Risk

Without fiscal unification, and in the absence of debt restructuring, the Euro will be under massive pressure to be broken up

We appreciate the bear arguments supporting the view that the Euro will ultimately be broken up. In essence, there is a lack of political accord between the member countries of the EU for the creation of a centralised taxation structure, which would collect tax revenues from all member states and distribute them for the benefit of the EU region as a whole, and particularly to those countries with fiscal deficits. We believe this is absolutely necessary for the long-term cohesive functioning of the EU, within the confines of a single Euro currency. Without fiscal unification, fiscal and economic imbalances (such as we are seeing in Greece, Portugal, Spain, Ireland and Italy) will likely deteriorate to the extent that a breakup of the Euro becomes inevitable. If this occurs (most probably by the departure of France or Germany, since weaker EU members cannot be forcibly ejected), then we believe this would cause enormous systemic risk, for the following reasons:

- Peripheral European sovereign debt denominated in the new, weaker Euro currency would suffer a technical default, since principal and interest are obliged to be paid in the current Euro currency. The debt would have to be written down accordingly (perhaps by as much as 30%, maybe more). All banks owning such debt would therefore take a direct hit to their equity.
- We know from the BIS data that the French and German banks, in aggregate, own substantial amounts of peripheral European sovereign debt. Not only would they suffer significant writedowns against their equity if the Euro were to break up, but their risk-weighted assets, largely denominated in a stronger French Franc or German Deutsche Mark, would inflate in relative terms, putting further pressure on capital ratios. The near €1tn bailout of the peripheral European countries is therefore, in our opinion, an indirect bailout of the French and German banks.
- Banks domiciled in peripheral Europe (Greece, Portugal, Spain, Ireland and Italy) would also suffer writedowns against their equity from the sovereign debt that they own. However, the impact on their capital ratios would be mitigated by the reduction in their risk-weighted assets, which would also be denominated in the new, weaker, Euro currency. We still envisage weakness in capital ratios (generally based on the assumption that the percentage fall in absolute capital will be greater than the percentage fall in RWAs for most of the peripheral European banks). However, perhaps the greatest risk for the peripheral European banks arises simply from the fact that their share prices would be worth significantly less in relative currency terms.
- We appreciate the view that a devalued currency would bring immediate benefits for the peripheral European countries in terms of international competitiveness. Exports would become cheaper, as would labour costs for international companies. Indeed, the UK's Centre for Economic and Business Research (CEBR) has recently advised the Greek government to leave the EU to solve its debt crisis. However, being no longer part of the EU would mean a lack of financial support from the ECB, which implicitly means a higher sovereign risk premium would be incorporated into borrowing costs, in addition to the other systemic risks discussed above.

No doubt hedging programmes, use of accrual accounting and the extent of duration matching (as well as other peculiarities) will make it difficult to determine quickly which banks will be the relative winners and losers should the Euro be broken up. However, our assertion is that the overall impact on the European banks sector would be overwhelmingly negative and would cause substantial systemic risk.

Voluntary Debt Restructuring Can Avert a Breakup of the Euro

The near €1tn bailout package affords the EU time (until at least Q1 2012) to put together a voluntary debt restructuring mechanism

Despite the lack of political accord between EU member states for a unified tax structure across the region, it is our view that the probability of the breakup of the Euro is very low. We believe it is far more likely that, within the time afforded by the near €1tn bailout package, a mechanism will be put in place which will allow the voluntary restructuring of peripheral European sovereign debt.

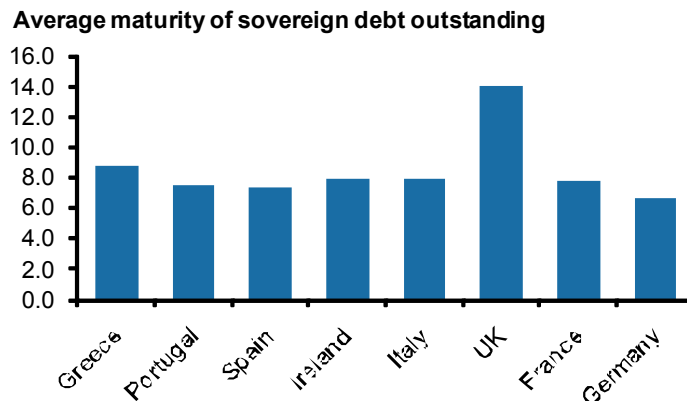
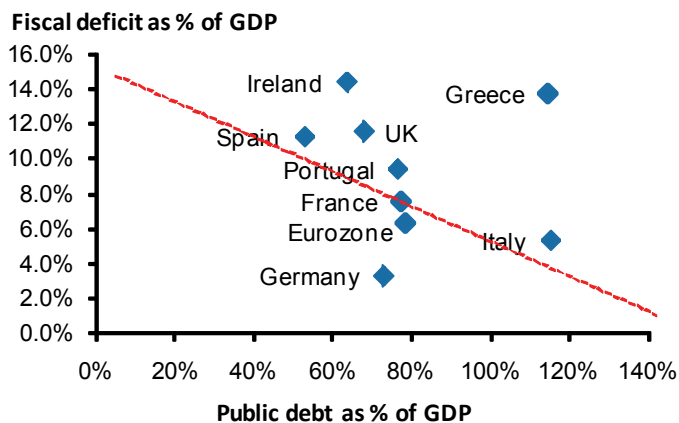
There are many forms of debt restructuring, ranging from a debt default and writedown (as advocated recently by the CEBR) to a voluntary rescheduling (as undertaken between Mexico and its multitude of creditors in the 1980s). In our opinion, voluntary debt rescheduling would be a better solution for the sovereign debt crisis. The main features and benefits would be as follows:

Debt rescheduling means that the servicing of the debt becomes more affordable over the long-term. The solvency of the sovereign improves

- The aim is to improve the solvency of the country with a fiscal deficit. Restructuring of the debt should therefore entail a terming out of the maturity and perhaps a reduction in the coupon rate (although creditors might hold out for an increase in the coupon rate as recompense for the maturity being extended). This would substantially alleviate the near-term requirement for the peripheral European countries to pay back principal in the next few years, allowing them to service their debt over the long-term more effectively. As can be seen in the charts below, the peripheral European countries have high fiscal deficits (and public debt) as a percentage of GDP, but also a short average maturity of sovereign debt outstanding. It is notable that the UK, while having high indebtedness, has in its favour a long average maturity of debt outstanding, as well as its own freely floating currency (allowing exports to be aided by the depreciation of sterling).

Figure 1: Peripheral European countries risk being unable to service their debt from GDP

Figure 2: Continental European countries have a short average maturity of sovereign debt outstanding



Source: Eurostat, Matrix Research

Source: Bloomberg, Matrix Research

Debt rescheduling does not result in a default of the debt. Writedowns are avoided and risks to bank capital adequacy are alleviated

- If the debt restructuring is 'voluntary' (i.e. the creditors agree to the maturity being termed out) then this does not technically result in a default. **Writedowns are therefore avoided and the European banks sector does not suffer a risk to its capital adequacy.**
- Similar to the Mexican experience of the 1980s, a single advisory committee to coordinate the debt rescheduling process between the sovereign and its multitude of creditors is absolutely necessary. This would preferably be a statutory body.
- The Euro remaining as a single currency means that the share prices of banks in the peripheral European countries are not devalued.

Problems With Voluntary Debt Rescheduling Are Manageable

We are aware that a voluntary debt rescheduling mechanism would not be without problems and that the path to successful implementation may be fraught with stock market volatility. However, we believe this outcome would be far less negative than a breakup of the Euro. Issues to be aware of include the following:

- CDS contracts purchased as insurance against default would be invalidated by the rescheduling of peripheral European sovereign debt. Such CDS contracts would have to be written off, implying a negative hit to equity for the purchasers. However, we do not see this, by itself, as causing systemic risk since there should be offsetting gains for the sellers of the CDS contracts (i.e. the business of writing and buying CDS contracts should be a 'zero-sum game'). The systemic risk posed should therefore be much less than if the sovereign debt itself was actually defaulted upon.
- If, as we expect, a voluntary debt restructuring mechanism is put into place, there could be a rush by creditors to sell the debt in advance of it being rescheduled. This would depress debt values no doubt, but it would accelerate plans for that debt to be voluntarily rescheduled in our opinion, therefore bringing forward the inevitable outcome. At some point, it would also be attractive to own the debt since, post rescheduling, there would be a greater likelihood of it being serviced and there would be less inherent sovereign default risk.
- Creditors would rationally only agree to a debt rescheduling if the value of the debt were such that doing so would make it an attractive proposition, i.e. that it was already at levels implying default. This would mean that a round of severe credit (and equity) market weakness is necessary before debt restructuring becomes the only viable outcome. Still, we believe that it will be the preferred outcome by EU politicians and regulators versus a breakup of the Euro. We are also hopeful that politicians and regulators will 'coerce' bank creditors into 'voluntarily' agreeing to a debt rescheduling for the greater good of the EU and its banking system, which would pre-empt the market weakness required to make debt rescheduling feasible.

A Final Word on Systemic Liquidity Risk

In our opinion, we are not facing systemic liquidity risk similar to that which occurred in Q4 2008. Then, with the collapse of Lehman Brothers on 15 September, many unintended consequences conspired to cause systemic risk, including:

- CDS contracts referencing Lehman as the underlying were suddenly triggered.
- CDS contracts where Lehman was the counterparty were no longer honoured.
- Highly rated commercial paper issued by Lehman and owned by money market funds were suddenly worth a lot less, causing the funds to "break the buck" and suffer a massive liquidation by their investors.
- Finally, many of Lehman's prime brokerage clients lost access to their collateral, forcing them to fire-sale other assets in order to reduce leverage and improve their own liquidity.

We do not foresee similar liquidity issues occurring at the present time. The ECB has now committed itself to a substantial programme of purchasing both private and public debt; (as of the week ending 28 May, European central banks had purchased approximately €35bn of such debt in the market, although the exact composition of this is unknown). Furthermore, there is still a substantial oversubscription of bids for the ECB one-week term deposit facility (which is designed to absorb excess liquidity from the system). The US Federal Reserve has agreed to reinitiate its US dollar

swap facility against ECB-eligible collateral. Also, the ECB has committed itself to further 3 and 6-month longer term refinancing operations (LTROs) with full allotment, and we believe it will continue to do so should the need arise.

Potential net losses on CDS contracts arising from a restructuring of sovereign debt would be relatively small in our view

The main similarity with the liquidity crisis of Q4 2008 that we foresee, if the current sovereign crisis is resolved by a debt restructuring, would be due to the invalidation of CDS contracts (as discussed above). However, we do not see this, by itself, as causing systemic liquidity risk, or indeed solvency risk. Certain banks would indeed incur losses on their marked-to-market CDS positions, but we believe this would be substantially offset by M-t-M gains made by the sellers of the CDS contracts (since the business of writing and buying CDS contracts should be a 'zero-sum game').

CHANGES TO TARGET PRICES

We believe the indiscriminate weakness in the sector represents an outstanding opportunity to buy certain banks cheaply. Our belief is that the prices of these stocks will increase appreciably once the market realises systemic risk is not a concern and that only some banks will be affected by sovereign risks.

Our high conviction BUY is Lloyds. We also have BUY ratings on the Nordic banks and Standard Chartered

Our strongest conviction BUY is **Lloyds**, which we believe will demonstrate a return to meaningful earnings in 2010. We also continue to like quality banks with strong capitalisation, growth opportunities and little exposure to sovereign risks, which we believe will be structural long-term outperformers. These include, **DNBNOR**, **Handelsbanken**, **Nordea** and **Standard Chartered**. Target prices for all our BUY rated stocks remain unchanged.

We remain negative on the peripheral European banks

We remain negative on the peripheral European banks **BBVA**, **Santander**, **Intesa** and **Unicredit**. We reduce our target price to €8.00 from €9.60 for BBVA (rated SELL), and to €9.50 from €11.30 for Santander (HOLD). This reflects our expectation of greater earnings weakness arising from the commitment to fiscal cutbacks in Spain, as well as the Bank of Spain's recent move to accelerate the provisioning calendar to only one year from two–six years.

We make modest reductions to €2.45 from €2.60 for Intesa (HOLD), and to €1.85 from €2.00 for Unicredit (SELL), again reflecting a greater expected impact on earnings from fiscal cutbacks.

We are also negative on HSBC versus Lloyds and Standard Chartered

Our target price for **HSBC**, rated SELL, remains unchanged. HSBC stands out somewhat as an anti-consensual call, given its apparent defensiveness in the current environment. However, we believe its lack of capital strength (affecting earnings and dividend growth) is likely to hamper stock price performance in the expected equity market recovery. In our view, it neither has the restructuring potential of Lloyds nor the growth prospects or capital strength of Standard Chartered.

Figure 3: Changes in Ratings and Target Prices

STOCK	Old Rating	New Rating	Old Target Price	New Target Price	% Change in Target Price	Yesterday's Closing Price	Upside / Downside
BBVA	SELL	SELL	9.60	8.00	-17%	8.17	-2.0%
DNB NOR ASA	BUY	BUY	86.00	86.00	0%	64.45	33.4%
HSBC HLDGS PLC	SELL	SELL	650.00	650.00	0%	650.60	-0.1%
INTESA SANPAOLO	HOLD	HOLD	2.60	2.45	-6%	2.15	14.1%
LLOYDS BANKING	BUY	BUY	80.00	80.00	0%	58.15	37.6%
NORDEA BANK AB	BUY	BUY	86.60	86.60	0%	64.45	34.4%
BANCO SANTANDER	HOLD	HOLD	11.30	9.50	-16%	8.43	12.7%
SVENSKA HAN-A	BUY	BUY	250.00	250.00	0%	193.80	29.0%
STANDARD CHARTERED	BUY	BUY	2050	2050	0%	1579	29.9%
UNICREDIT SPA	SELL	SELL	2.00	1.85	-8%	1.87	-1.3%

Source: Matrix Research

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Company	Disclosure
BBVA	None
DNB NOR ASA	None
HSBC Holdings	None
Intesa Sanpaolo	None
Lloyds Banking	None
Nordea Bank	None
Banco Santander	None
Svenska Han-A	None
Standard Chartered	None
Unicredit	None

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