The Europe Rescue Plan

Summary

On 9 October 2011, Germany and France agreed to deliver a plan on 3-4 November (as part of G20 Summit) to tackle the worsening sovereign debt crisis. The main aim of the plan is to help insulate the European banking sector from the repercussions of a Greek debt restructuring amid spreading sovereign contagion risk. This article examines the investment implications of the plan.

While the details are still being hammered out, it is clear that European banks need to build up adequate capital buffer to withstand the current debt crisis and possibly more severe haircuts to Greek bonds. This will be done in three steps. Firstly, the troubled banks will have to try to raise capital on their own, failing which, they will then turn to national governments for help. Banks will seek aid from the European Financial Stability Facility ("EFSF") only as a last resort, if the first two steps prove insufficient.

But basically, for the plan to be effective, Europe needs a sizeable and comprehensive bank recapitalization budget that can sufficiently ring-fence the European banking system from a Greek default and its contagion effect on the other peripheral economies. The authorities also need to bump up the EFSF's funding size to help contain sovereign debt risk and help keep peripheral economies' bond yields at manageable levels.

The outcome of the European debt crisis is the single most important event that will determine the direction of the global equity markets. European equities could find a bottom and rally strongly, if the European authorities can present a credible and comprehensive plan to contain the sovereign debt crisis and recapitalize the beleaguered banking system.

But if Europe disappoints with an ill-devised plan, then the market reaction will be brutal.

Overall, we maintain our defensive posture for the European market and continue to focus on the Defensive sectors and fundamentally strong companies with resilient earnings outlook.

On 9 October 2011, Germany and France agreed to deliver a plan on 3-4 November (as part of G20 Summit) to tackle the worsening sovereign debt crisis. The main aim of the plan is to help insulate the European banking sector from the repercussions of a Greek debt restructuring amid spreading sovereign contagion risk. This article examines the investment implications of the plan.

European Stress Points

In recent weeks, there have been intensive policy debates on how best to ring-fence the European banking system against a Greek default. This comes amid growing international pressure on Europe to come up with a cohesive and strong response to address fears that its debt troubles could become a systemic global threat.

Those fears are not without basis, going by the widening spreads on European debt. By August this year, European yields on 10-year Italian government debt jumped 128 basis points to hit a 15-year high of 6.2 per cent in early August compared with a month ago. Typically, a country finds the debt financing burden unbearable when yields cross the 7 per cent threshold level and has to later tap government funding support. Similar funding stress was seen in Spain and in core Europe such as France. Despite European Central Bank's ("ECB") intervention in the secondary bond market, both the Italian and Spanish bond yields persisted in staying above their five-year average levels.

Meanwhile, those troubles appear to be spilling over into the banking sector, as European banks faced increasing funding problems. This could be seen by the rising Euro Interbank Offered Rate ("Euribor") spreads, which rose to 89 basis points in September - the highest level since 2009. Fortunately, the ECB stepped in to provide unlimited liquidity to the European banking system, and that helped to keep the Euribor spreads well below the levels seen during the 2008 Lehman Brothers' collapse.

Another source of contagion came from Greece's continual failure to meet the fiscal targets set by Troika, comprising European Commission, the IMF and the European Central Bank. For this reason, the country did not receive its sixth tranche payment of EUR8 billion on 10 October which has been postponed to mid November.

Another issue has to do with the "Private-Sector-Involvement" (PSI) scheme as part of the second bailout package to Greece totaling €159 billion in July this year. Under the scheme, the bondholders will have to accept a 21 per cent loss on their Greek debt holdings. However, recent headlines suggest that Germany is now demanding a larger haircut of around 40 per cent to 60 per cent on Greek debt given the country's deteriorating fiscal position.

The Plan

In response to growing sovereign debt problem, German Chancellor Angela Merkel and French President Nicolas Sarkozy stated on 2 October, after a joint meeting, that Europe would deliver a plan to recapitalize European banks and address the Greek debt crisis. Such a plan should be ready by 3 November at the next G20 summit.

While the details are still being hammered out, it is clear that European banks need to build up adequate capital buffer to withstand the current debt crisis and possibly more severe haircuts to Greek bonds. This will be done in three steps. Firstly, the troubled banks will have to try to raise capital on their own, failing which, they will then turn to national governments for help. Banks will seek aid from the European Financial Stability Facility ("EFSF") only as a last resort, if the first two steps prove insufficient.

But basically, for the plan to be effective, Europe needs a sizeable and comprehensive bank recapitalization budget that can sufficiently ring-fence the European banking system from a Greek default and its contagion effect on the other peripheral economies. The authorities also need to bump up the EFSF's funding size to help contain sovereign debt risk and help keep peripheral economies' bond yields at manageable levels.

Bank Recapitalization

One way to boost the credibility of any bank recapitalization exercise is to model it after the US Troubled Asset Relief Program ("TARP"), where precautionary capital is injected in a coordinated and comprehensive way to multiple banks. If done properly, this will help to strengthen confidence and help ease funding concerns as was the case in the US. Only then can Europe can stand a chance of breaking out of the negative feedback loop from the sovereign problems to the European banks' balance sheets.

Also, the assumptions used in any such exercise should be more rigorous than what we saw in the last European bank stress test in July this year. The test not only failed to assure the markets, given the lenient assumptions used, but it was unable to identify a "reasonable level of stress" in the banking system. For example, the estimated sovereign bond hair cuts were too low. Unbelievably, only eight banks failed the test, with a total shortfall of €8 billion. In fact, the failed Belgian bank, Dexia, had passed the test with "flying colours" but went belly-up three months later.

So what would constitute a credible additional capital buffer size? Some estimates put the capital shortfall for European banks at around €175 billion. This is based on the July European Banking Authority stress test results assumptions and estimated sovereign haircuts on the European periphery – 60 per cent for Greece, 50 per cent for Ireland and Portugal, 10 per cent for Spain and 7 per cent for Italy. The shortfall rises to €245 billion when the haircut assumptions on Italian and Spanish sovereign bonds rise to 20 per cent. This is consistent with IMF's estimate of a €200 billion capital shortfall in the European banking system.

The EFSF Firepower

At the same time, the bank recapitalisation plan needs to be reinforced by an enlarged EFSF to help contain any second-round effects of a deeper debt restructuring in Greece. In its original form, the EFSF's funding will run low, if it is used to bolster the capital position of the weaker European banks.

Assuming that a conservative €100 billion of EFSF's €440 billion is used to fund banks' capital shortfall, this leaves the Fund with only €340 billion in its kitty. With an estimated €52.7 billion earmarked for a second Greek package and additional spending on Ireland and Portugal amounting to around €35 billion, the remaining funding capacity of the Facility dwindles to around €212 billion. Given that Italy and Spain need about €785 billion in refinancing over the period 2012 to 2014, the EFSF's fund size is insufficient for any further support of peripheral sovereigns.

However, there are a few possible ways to raise the EFSF's funding potential. These are:

1. The EFSF will guarantee a portion of new bonds issued by debt-strapped European countries. For example, if EFSF insures the first 50 per cent of losses, then this has the effect of doubling the Fund's leverage.
2. Leveraging up on the EFSF or a Special Purpose Vehicle via the ECB. This means that the central bank will have to increase its balance sheet meaningfully and absorb increased credit risk. Although this is a powerful way to expand the size of the EFSF by four to five times, ECB and Germany have voiced concerns about this approach.
3. To bring forward the launch of the European Stability Mechanism (ESM) scheduled for June 2012. The ESM is more flexible than the EFSF and can be leveraged up much more easily.
4. Issuing Eurobonds but this requires European fiscal integration first, and this requires a lengthy ratification by all the national European parliaments to effect the necessary Constitutional and Treaty changes.

Conclusion

The outcome of the European debt crisis is the single most important event that will determine the direction of the global equity markets. European equities could find a bottom and rally strongly, if the European authorities can present a credible and comprehensive plan to contain the sovereign debt crisis and recapitalize the beleaguered banking system.

Markets will be particularly pleased, if the plan includes measures to enhance the EFSF's funding size, as this will ensure ample liquidity for the peripheral countries. It is also noteworthy that the European markets are now trading at about 8.4x forward earnings, which represents a 41 per cent discount to the long-run average of 14.2x. Using the long term average as the fair value, the market could have priced in a recession.

But if Europe disappoints with an ill-devised plan, then the market reaction will be brutal.

Overall, we maintain our defensive posture for the European market and continue to focus on the Defensive sectors and fundamentally strong companies with resilient earnings outlook.

Contact Details

Address 80 Raffles Place UOB Plaza 2 Level 3 Singapore 048624
24-hour Hotline 1800 222 2228 (Local) • (65) 6222 2228 (International)
Fax (65) 6532 3868
Email uobam@uobgroup.com
Website uobam.com.sg

Business Offices

Singapore
Institutional Business
Dennis Siew
Senior Director

Retail Business
Norman Wu
Senior Director

New Strategic Markets & Private Banks
Rachel Ong
Director

Brunei
Kamal Muhd
General Manager

Japan
Masashi Ohmatsu
Chief Executive Officer

Malaysia
Lim Suet Ling
Chief Executive Officer

Greater China/Taiwan
William Wang
Chief Executive Officer

Thailand
Vana Bulbon
Chief Executive Officer

Important Notice & Disclaimers

This publication shall not be copied or disseminated, or relied upon by any person for whatever purpose. The information herein is given on a general basis without obligation and is strictly for information only. This publication is not an offer, solicitation, recommendation or advice to buy or sell any investment product, including any collective investment schemes or shares of companies mentioned within. Although every reasonable care has been taken to ensure the accuracy and objectivity of the information contained in this publication, UOB Asset Management Ltd and its employees shall not be held liable for any error, inaccuracy and/or omission, howsoever caused, or for any decision or action taken based on views expressed or information in this publication. The information contained in this publication, including any data, projections and underlying assumptions are based upon certain assumptions, management forecasts and analysis of information available and reflects prevailing conditions and our views as of the date of this publication, all of which are subject to change at any time without notice. UOB Asset Management Ltd ("UOBAM") does not warrant the accuracy, adequacy, timeliness or completeness of the information herein for any particular purpose, and expressly disclaims liability for any error, inaccuracy or omission. Any opinion, projection and other forward-looking statement regarding future events or performance of, including but not limited to, countries, markets or companies is not necessarily indicative of, and may differ from actual events or results. Nothing in this publication constitutes accounting, legal, regulatory, tax or other advice. The information herein has no regard to the specific objectives, financial situation and particular needs of any specific person. **You may wish to seek advice from a professional or an independent financial adviser about the issues discussed herein or before investing in any investment or insurance product. Should you choose not to seek such advice, you should consider carefully whether the investment or insurance product in question is suitable for you**.

UOB Asset Management Ltd Co. Reg. No. 198600120Z