S&P CAPITAL IQ

Solutions Exchange Product Spotlight

The Increasing Cost Of Insuring Against The Global Financial Crisis

Pavle Sabic, FRM
Primary Analyst
Solutions Architect
(44) 20-7176-3730
Pavle_Sabic@spcapitaliq.com

Solutions Exchange is developed by S&P Capital IQ's Solutions Architects, a separate and independent team at Standard & Poor's. The objective of this analysis is to gain greater insight into specific events and trends in the market using S&P Capital IQ data and analytics solutions.

Despite indications that the U.S. economy is likely to avoid a recession in the short term, the debt crisis in Europe continues to strain the global financial system. S&P Capital IQ's Solutions Architect team reviewed trends associated with insuring against default risk and found that costs have reached record levels. Recent widening in five-year credit default swap (CDS) spreads for systematically important financial institutions (SIFIs) and their sovereigns reflect this trend.

Global CDS Spreads Continue To Rise

In November 2011, the Financial Stability Board (FSB) identified 29 systematically important financial institutions (SIFIs; see table 1). According to the FSB, "SIFIs are financial institutions whose distress or disorderly failure, because of their size, complexity and systemic interconnectedness, would cause significant disruption to the wider financial system and economic activity." Since August 2008, five-year CDS spreads for almost all of these institutions have exceeded their 2008 to 2009 financial-crisis highs. Moreover, current CDS spreads have reached all-time record highs, illustrating the record costliness of insuring against default risk.

Chart 1 shows a comparison of CDS levels over time. The red circles show spread levels for the SIFIs as of Feb. 23, 2012. Out of the 29 SIFIs, Dexia S.A. has the widest spread, at 688 basis points (bps), followed by UniCredit SpA, at 363 bps. Wells Fargo & Co. and JPMorgan Chase & Co. have the lowest spreads, of 106 and 117 bps, respectively. The average spread in 2010 seemed to drop below 2009 averages in some instances (Bank of America Corp., Citigroup Inc., The Goldman Sachs Group Inc., Wells Fargo & Co., Barclays PLC, UBS AG, Dexia S.A., Nordea Bank AB, Mitsubishi UFJ Financial Group Inc., and Bank Of China). However, spreads for all but Citigroup and Wells Fargo have increased to their current highs. CDS spreads for Citigroup and Wells Fargo have decreased to below their 2009 highs.

Now that the entities in question have been forced to step up their capital buffers, tighten their belts on risk management, and adapt to new regulations, more of the risk concerns have begun to shift to the sovereigns in which they operate. In order to understand the cost of insuring against direct sovereign defaults, we individually assessed the sovereign SIFI governments, which have a more vested interest in the stability of the SIFIs than ever before.

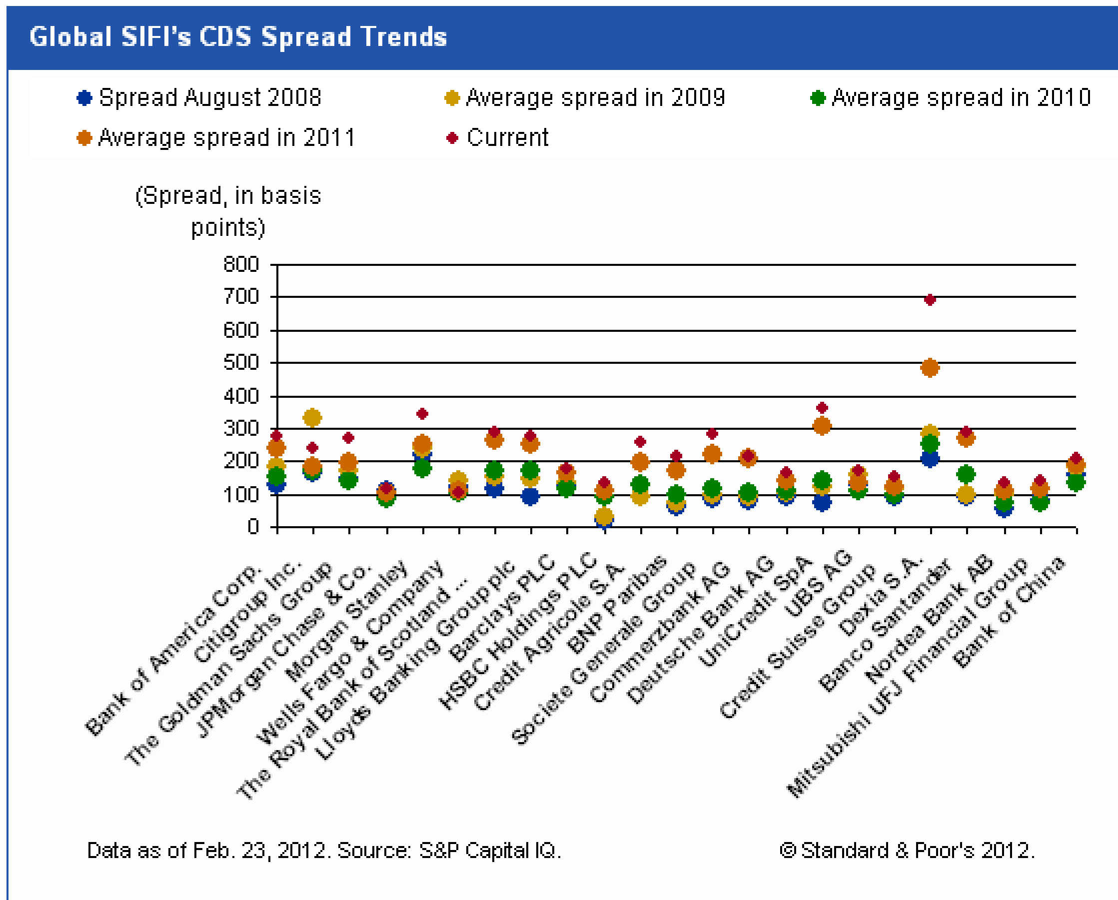
Table 1

Financial Stability Board's List Of 29 SIFIs

	SIFIs (count)	Companies
U.S.	8	Bank of America, Bank of New York Mellon, Citigroup, Goldman Sachs, JP Morgan, Morgan Stanley, State Street*, Wells Fargo
U.K.	4	Royal Bank of Scotland, Lloyds Banking Group, Barlcays, HSBC Holdings
France	4	Crédit Agricole, BNP Paribas, Banque Populaire*, Societe Generale
Germany	2	Deutshe Bank, Commerzbank
Italy	1	Unicredit Group
Switzerland	2	UBS, Credit Suisse
Belgium	1	Dexia
Netherlands	1	ING Groep*
Spain	1	Banco Santander
Sweden	1	Nordea
Japan	3	Mistubishi, Mizuho*, Sumitomo Mitsui*
China	1	Bank of China
Total	29	Of which 23 have CDS

*Does not have CDS data as of Feb. 23, 2012. Source: S&P Capital IQ.

Chart 1

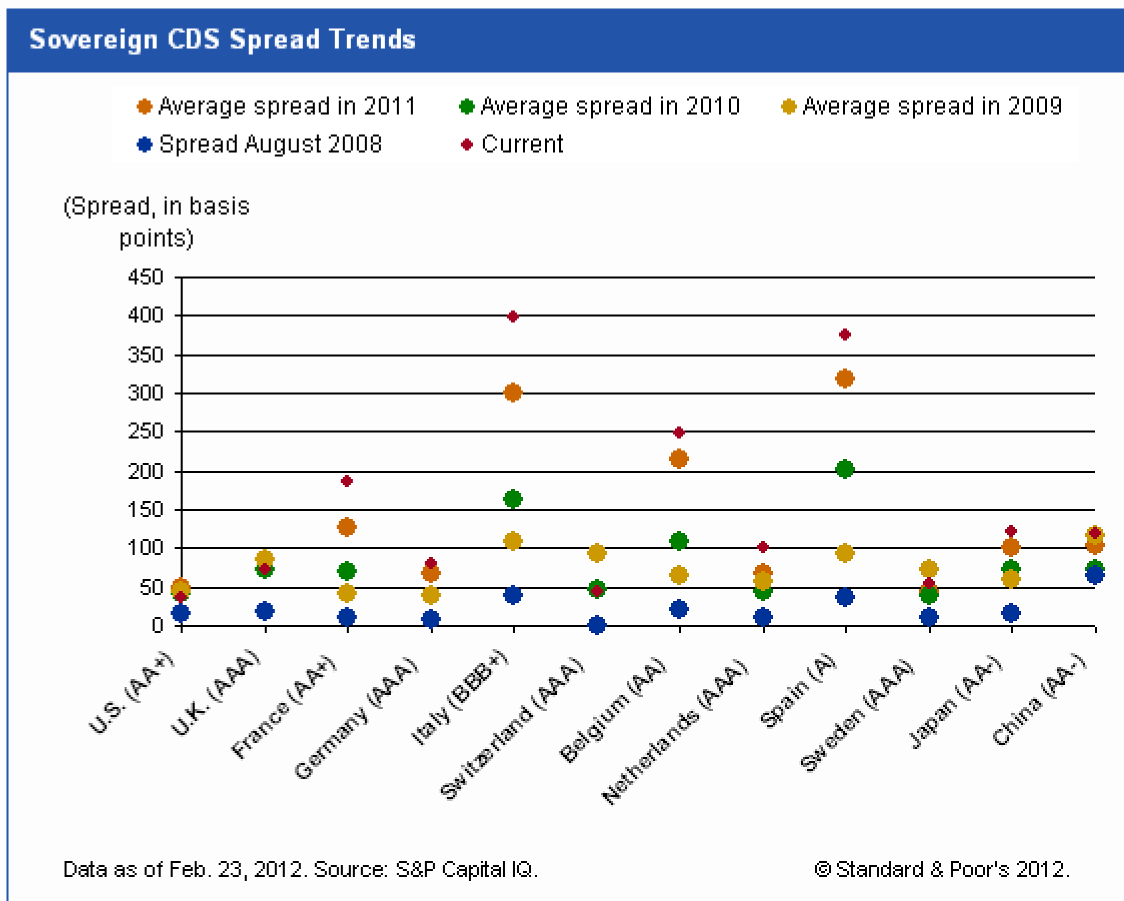


Are Sovereigns "Too Big To Fail?"

Based on the bailouts currently underway in the European Economic and Monetary Union (EMU, or eurozone), the answer appears to be no. But what is the cost of insuring against sovereign defaults? Chart 2 shows the results of the CDS spread analysis on the 12 sovereigns listed in table 1. Again, we found that the majority of the sovereigns now have higher CDS spreads than over the period from Aug. 1, 2008, to Feb. 23, 2012. Much to the delight of British investors, U.K.'s current five-year CDS spread is among the lowest of the 12 nations, with U.S. spreads safely at the bottom, at 35 bps. Some nations have managed to buck the trend of surging spreads; CDS spreads for the U.S., U.K., Switzerland, and Sweden have dropped below their 2009 average.

Germany is the only large economy left in the eurozone (highest nominal GDP for eurozone countries) with a 'AAA' rating, after Standard & Poor's Ratings Services recently lowered its rating on France to 'AA+' from 'AAA'. This may cause investors to further turn to Germany as a safe haven, which would typically raise the price of German bonds and lower yields. We believe that this flight to quality will continue to increase the reliance on Germany to keep the euro afloat.

Chart 2

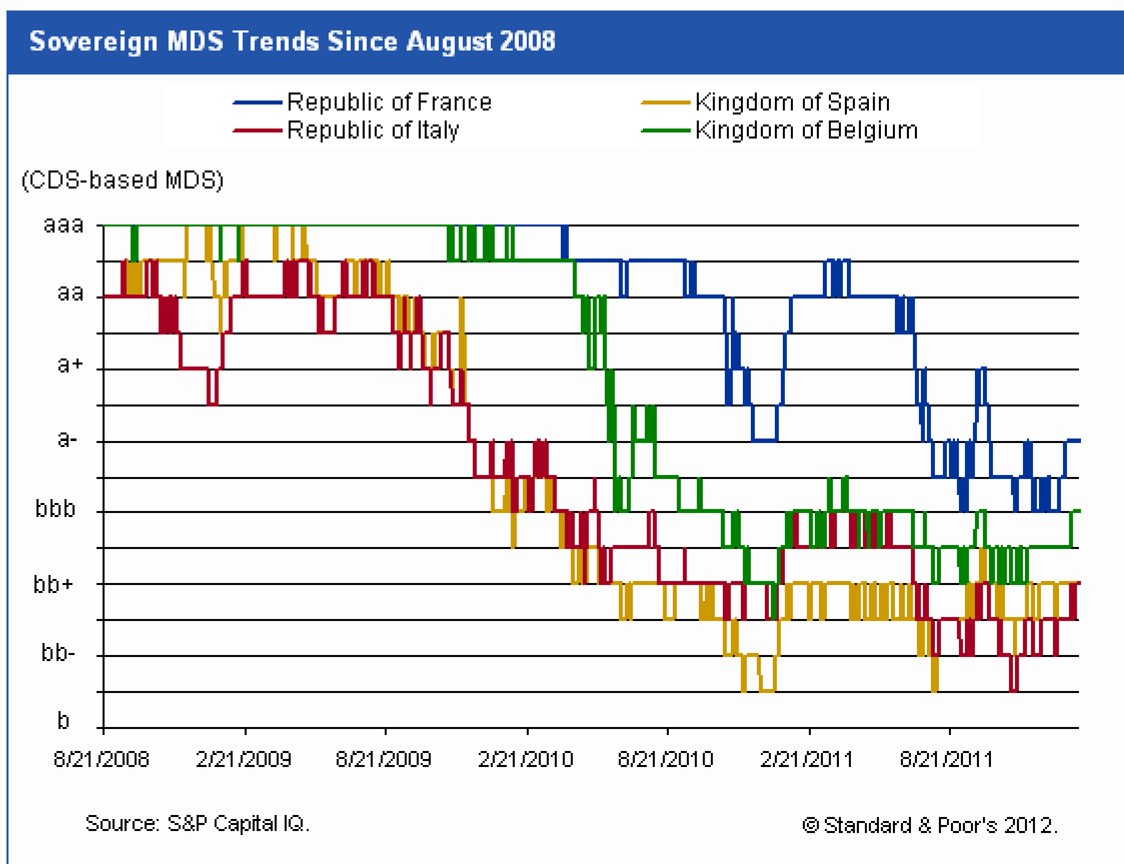


Early Warning Signs Of Sovereign Debt Deterioration

S&P Capital IQ Market Derived Signals (MDS) provide a score, quantitatively derived from the CDS spreads, used to assess the market's current view of an entity's perceived credit quality. Daily MDS changes allow risk managers to keep tabs on the market's perception of credit risk, whereas Standard & Poor's credit ratings are more stable and reflect a long-term view of the sovereign's creditworthiness. Chart 3 plots sovereign MDS trends since August 2008 for four sovereigns central to the current eurozone crises (France, Spain, Italy, and Belgium). While they may reflect different views of credit for these sovereigns, the MDS and credit ratings have been falling for each. For example, France has had a MDS of 'aa+' or lower since April 9, 2010, with the MDS dropping as low as 'bbb' since that time. Standard & Poor's also changed its view of the creditworthiness of France, placing its 'AAA' rating on France on CreditWatch with negative implications on Dec. 5, 2011, and subsequently downgrading the sovereign to 'AA+' on Jan. 26, 2012, with a negative outlook.

Italy's MDS has shown a downward trend in credit quality since November 2009, when it reached 'a'. On May 20, 2011, Standard & Poor's revised its outlook on its 'A+' rating on Italy to negative, and subsequently downgraded the sovereign to 'A' with a negative outlook on Sept. 19, 2011. Standard & Poor's then downgraded Italy to 'BBB+' from 'A' on Jan. 13, 2012.

Chart 3



Sovereign Risk Versus Country Risk

Both the CDS and the MDS can be used as indicators for market perceptions of sovereign credit risk. Sovereign risk and country risk are conceptually distinct in the following ways:

- Sovereign risk measures the risk of a country defaulting on its debt obligations.
- Country risk measures the risk of a country's business environment, including the legal environment, levels of corruption, and socioeconomic variables such as income disparity.

Someone analyzing a corporation needs to consider not only the credit risk of the sovereign in which it operates, but also the risk of doing business within that nation. The fusion of these two risks may lead to instances where the sovereign and country risk may diverge significantly and present conflicting views of that nation. For example, Standard and Poor's currently has a 'BBB' rating on the Russian Federation. We have ranked Standard & Poor's ratings scale to a numerical equivalent, where 1 is equivalent to 'AAA', 2 to 'AA+', etc. Therefore, we interpret Standard & Poor's 'BBB' rating on Russia as a rank of 9 out of 20. However, S&P Capital IQ considers Russia to have a numerical score of 14 for country risk. This divergence may require further scrutiny when attempting to model corporations within Russia. (1)

Conclusion

CDS spreads and S&P Capital IQ's MDS provide investors with another source of information from which they can derive their own view of an entity's creditworthiness. Our findings suggest that the risk of insuring against default has reached new highs, both for corporations and sovereigns.

While we may still want to keep an eye on weekly political meetings between German Chancellor Angela Merkel and French president Nicolas Sarkozy, quantitative credit indicators as shown in this article might provide additional prior warnings to potential corporate and sovereign downturns.

Getting Behind The Data

To perform the analysis in this article, we used the following S&P Capital IQ solutions:

Global Credit Portal

Standard & Poor's RatingsDirect on the Global Credit Portal provides real-time access to integrated credit research, market information, and risk analytics. This dynamic web-based platform leverages the latest content and technology to give subscribers the actionable credit market intelligence needed to help assess exposure and capitalize on investment opportunities.

S&P Capital IQ Excel Plug-in

Simplify the process of building and updating financial models with our intuitive Excel Plug-In. Quickly populate and update your spreadsheets with financial, market, and company data with our easy-to-use Formula Builder.

Market Derived Signal

Standard & Poor's created its Market-Derived Signals (MDS) to capture the market's sentiment regarding a company's perceived credit risk. We base MDS on credit default swap (CDS) spreads and augment them using proprietary modeling techniques that adjust for certain variables. Since CDS contracts provide protection against default, we believe these spreads can provide inferences about the market's view of credit risk. While MDS use a letter scale similar to Standard & Poor's traditional rating scale, they're differentiated by lowercase letters that represent an indication of the CDS market's

view of risk but indicate that MDS are not actual credit ratings. MDS scores are analytically independent from S&P Credit Ratings and is driven by a market view of an issuer's credit health and expressed by lowercase letters. (See "Report Explains Standard & Poor's Market-Derived Signals Model," published June 8, 2009, on RatingsDirect.)

Notes

(1) Marcel Heinrichs and Invelina Stanoeva, "Country risk and sovereign risk – building clearer borders," S&P Capital IQ, The EUROMONEY Risk Management Handbook 2012, Chapter 3, Jan. 1, 2012.

Copyright © 2012 by Standard & Poor's Financial Services LLC. All rights reserved.

This report was prepared by the S&P Capital IQ Global Markets Intelligence group, formerly known as the Global Markets Intelligence research group. This group is analytically and editorially independent from any other analytical group at S&P.

No content (including ratings, credit-related analyses and data, model, software or other application or output therefrom) or any part thereof (Content) may be modified, reverse engineered, reproduced or distributed in any form by any means, or stored in a database or retrieval system, without the prior written permission of Standard & Poor's Financial Services LLC or its affiliates (collectively, S&P). The Content shall not be used for any unlawful or unauthorized purposes. S&P and any third-party providers, as well as their directors, officers, shareholders, employees or agents (collectively S&P Parties) do not guarantee the accuracy, completeness, timeliness or availability of the Content. S&P Parties are not responsible for any errors or omissions (negligent or otherwise), regardless of the cause, for the results obtained from the use of the Content, or for the security or maintenance of any data input by the user. The Content is provided on an "as is" basis. S&P PARTIES DISCLAIM ANY AND ALL EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE, FREEDOM FROM BUGS, SOFTWARE ERRORS OR DEFECTS, THAT THE CONTENT'S FUNCTIONING WILL BE UNINTERRUPTED, OR THAT THE CONTENT WILL OPERATE WITH ANY SOFTWARE OR HARDWARE CONFIGURATION. In no event shall S&P Parties be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs or losses caused by negligence) in connection with any use of the Content even if advised of the possibility of such damages.

Credit-related and other analyses, including ratings, and statements in the Content are statements of opinion as of the date they are expressed and not statements of fact. S&P's opinions, analyses, and rating acknowledgment decisions (described below) are not recommendations to purchase, hold, or sell any securities or to make any investment decisions, and do not address the suitability of any security. S&P assumes no obligation to update the Content following publication in any form or format. The Content should not be relied on and is not a substitute for the skill, judgment and experience of the user, its management, employees, advisors and/or clients when making investment and other business decisions. S&P does not act as a fiduciary or an investment advisor except where registered as such. While S&P has obtained information from sources it believes to be reliable, S&P does not perform an audit and undertakes no duty of due diligence or independent verification of any information it receives.

To the extent that regulatory authorities allow a rating agency to acknowledge in one jurisdiction a rating issued in another jurisdiction for certain regulatory purposes, S&P reserves the right to assign, withdraw, or suspend such acknowledgement at any time and in its sole discretion. S&P Parties disclaim any duty whatsoever arising out of the assignment, withdrawal, or suspension of an acknowledgment as well as any liability for any damage alleged to have been suffered on account thereof.

S&P keeps certain activities of its business units separate from each other in order to preserve the independence and objectivity of their respective activities. As a result, certain business units of S&P may have information that is not available to other S&P business units. S&P has established policies and procedures to maintain the confidentiality of certain nonpublic information received in connection with each analytical process.

S&P may receive compensation for its ratings and certain analyses, normally from issuers or underwriters of securities or from obligors. S&P reserves the right to disseminate its opinions and analyses. S&P's public ratings and analyses are made available on its Web sites, www.standardandpoors.com (free of charge), and www.ratingsdirect.com and www.globalcreditportal.com (subscription), and may be distributed through other means, including via S&P publications and third-party redistributors. Additional information about our ratings fees is available at www.standardandpoors.com/usratingsfees.

The McGraw·Hill Companies