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SPECIAL COMMENT

Sovereign Contagion Risk – Part I: Assessing the Impact on Banking Systems of Southern Europe,[1] Ireland and the UK

Despite differing circumstances, sovereign contagion risk could become a common theme

Table of Contents:

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Summary Opinion

The recent downgrade of Greek banks[2] has highlighted the contagion risk for banks stemming from the deterioration of their domestic sovereign credit profile and related market pressures. The banking systems of Portugal, Spain, but also Ireland, the UK and Italy are increasingly moving into the focus of the markets. Although the challenges in these six countries are different, the potential for contagion from their sovereign as observed in Greece is also spreading to some other countries, and to the extent this affects these countries it could dilute some of the inherent differences of the banking systems and impose a common threat.

As the financial strength of the banking systems of Ireland, the UK and Spain have deteriorated over the last two years the actions of the respective governments (and their Central Banks) have, to a large extent, mitigated the weaknesses that have come to light. This has been completed through various support packages including NAMA and recapitalisations in Ireland, the APS and recapitalisations in the UK and the FROB in Spain.

To date there has been little impact of the crisis in Italy whereas in Greece the downgrades of the bank ratings have resulted from the recent severe pressure on the sovereign. Despite many fundamental differences to Greece, Portugal is now at the forefront of investor concern if the risk of contagion continues – a key factor in this will be the market's view of the likely success or otherwise of the recently agreed IMF and European Union support package. But in all three countries – Greece, Portugal, Italy - the banks are challenged, or could potentially be, more as a consequence of the pressures on the sovereign rather than due to their own inherent creditworthiness. And this contagion could also extend to the systems of Spain, Ireland and the UK where the sovereign has been weakened by the developments within the banking system.

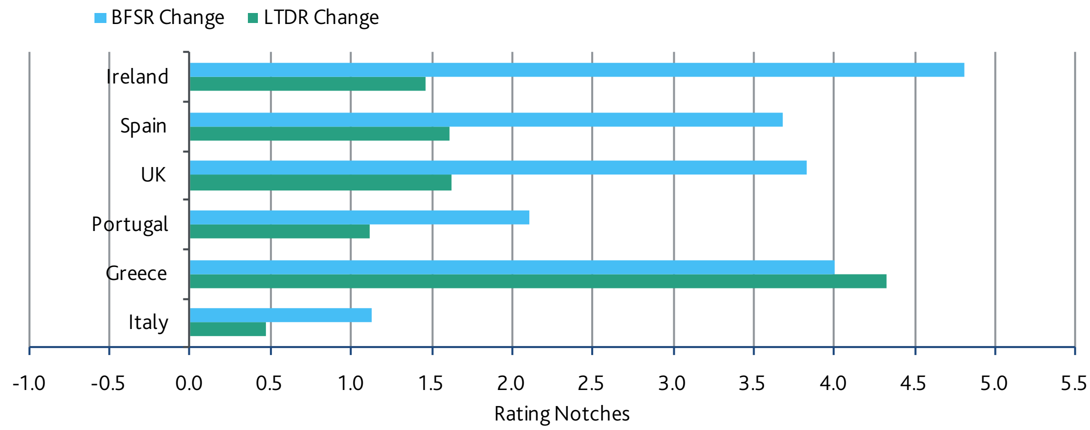
[1] For the purposes of this report Southern Europe refers to Greece, Italy, Portugal and Spain. In this first part of this series, we also include the banking systems of Ireland and the UK.

[2] Please refer to the Press Release "Moody's downgrades nine Greek banks" published April 30, 2010.

This report, the first of a two-part series, is based on a presentation that was made to investors in various European cities throughout April 2010 and will assess the risk of contagion to banking systems emanating from these sovereign concerns. The second part of this series – which will be published shortly – will assess the exposures and capital implications for major European banking systems to the four Southern European countries.

FIGURE 1

Average Change in Ratings between January 2008 and April 2010



(The ratings of Portuguese and Greek banks are under review for possible downgrade)

Position of the Banking Systems at the Outset of the Sovereign Confidence Crisis

The six banking systems that are examined in this Special Comment have faced some common challenges, such as the global economic decline and recession as well as the increased dependence on wholesale funding as loan books grew faster than deposits in the years up to 2007. However, there are also some very different challenges that the individual banking systems are currently facing (please see Figure 2 below):

i. Those with ***"Bottom-up"*** challenges are the systems that have experienced rapid loan and especially rapid real estate loan growth leading to unbalanced economies and significant adjustment needs. We would place Ireland and Spain in this category, but note that the exit strategies for the banking systems are very different – see sections below.

ii. The countries with ***"Top-down"*** challenges would be Greece, Portugal and possibly, albeit less likely in our view, Italy. These are the systems with primarily sovereign-related concerns where we believe that austerity packages and market-induced contagion may lead to negative pressure on the creditworthiness of the banking system, but where the banking systems themselves have not been the cause of the problems.

iii. The third category is the UK which is, in our view, working its way through a series of challenges towards recovery. The UK is in a difficult position: if it were to tighten fiscal conditions too quickly, then this could lead to further asset quality challenges in the banking system, potentially choking off economic recovery. Alternatively, if the UK did not tighten fiscal conditions soon and credibly enough, then the financial flexibility of the sovereign may diminish as market opinion may move against the UK. Any increase in the funding costs of the government would lead to further pressure on bank profitability as individual bank funding costs would also be likely to increase.

FIGURE 2

Key Factors

COUNTRY	UNITED KINGDOM	IRELAND	SPAIN	ITALY	PORTUGAL	GREECE
Recession	√	√	√	√	√	√
Funding Challenges	√	√	√	(√)	√	√
Real Estate / Loan Growth	(√) (overall moderate, but some pockets [e.g. CRE])	√	√			(√) (more in line with Emerging Markets)
System leverage (Households, Sov, Corp., FI's)	√	√				
Recapitalisation	√	√	(√) Funds made available, not yet being utilised			
Balance-Sheet clean-up enforced	(√) (only partially via stress tests and APS)	√	(√) (in progress, but facing obstacles)			
Fiscal tightening	(√) (anticipated to start after elections in May)	√	√		√	√

In the following paragraphs, we will examine some of the key factors that affect these banking systems such as:

A) The size of the banking systems relative to their country's GDP

B) The contribution of the real estate sector to the challenges

C) The response of the state

D) Sovereign strength and economic performance as an important input into banking system strength

All these categories highlight the differences, and we will conclude with a country-by-country summary highlighting these. However, we remain cautious that market concerns may cause contagion risk that belies these differences, and that such market sentiment can be sufficiently strong (and long-lasting) to create its own reality and expose all these countries to a common threat.

A. The Size of Banking Systems Relative to Their Country's GDP

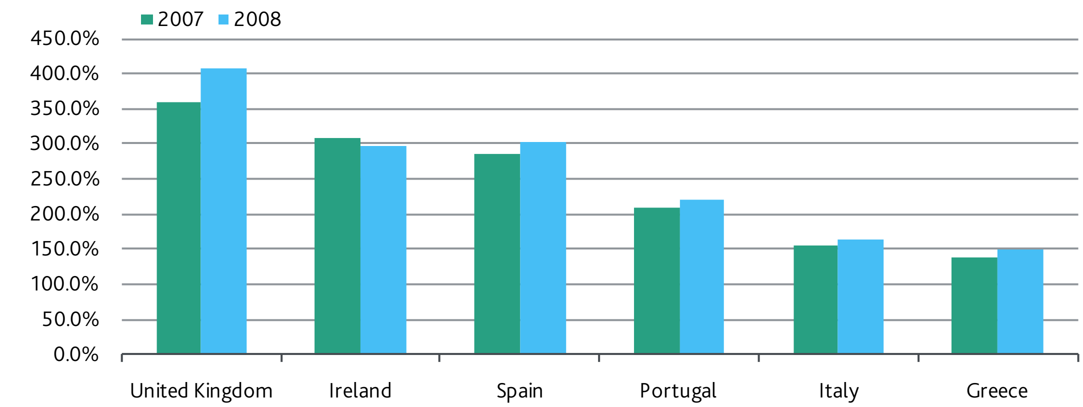
The size of the UK banking system creates particular challenges

An aspect to bear in mind when assessing the interaction between the economy and its banking system is the relative importance of that banking system to its economy. In the UK, the weakness of the banks has had a large impact on the economy given the banking sector's relatively large contribution to

GDP (see Figure 3). Any impact on sovereign creditworthiness can therefore have a relatively strong impact on the banking system, and vice versa. At the same time, the generally accepted need to reduce leverage in the system will be challenging as it can have severe consequences on GDP. In countries where the banking system plays a much smaller role – such as Portugal and Italy - the contagion risk from banks towards the overall economy remains much less pronounced.

FIGURE 3

Importance of the Banking Systems (Domestic Banking Assets % GDP)



Source: European Central Bank

Different approaches in Ireland and Spain to deal with inflated banking sector

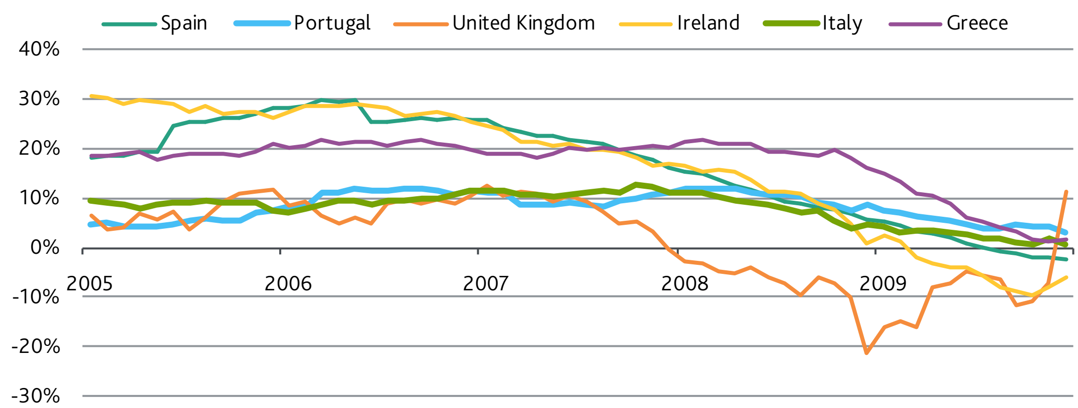
In Ireland and Spain the rapid inflation of banking assets due to the real estate bubbles has over-emphasised the contribution of the banking system. The required "downsizing" is leading to a necessary but painful adjustment, especially in Ireland where a drastic clean-up and recapitalisation of the banking system is taking place as a result of NAMA, the recapitalisation led by the Irish government and the new minimum capital targets for those banks participating in NAMA.

While the Spanish government has also earmarked up to €100 billion for the recapitalisation of Spanish banks, the approach taken so far by the countries' savings banks – the most affected – is very different: the sector is seemingly intent on "earning its way out of the crisis", hoping to generate sufficient internal capital to absorb the losses stemming from impaired assets. This will require some time and needs to be accompanied by an accommodating regulatory and accounting framework. The banks also need sufficient liquidity throughout that period, and the ECB remains their primary source of wholesale funds at present. Without such liquidity, a more rapid and drastic "clean-up" of the banks may still become necessary.

B. The Contribution of the Real Estate Sector to the Challenges

FIGURE 4

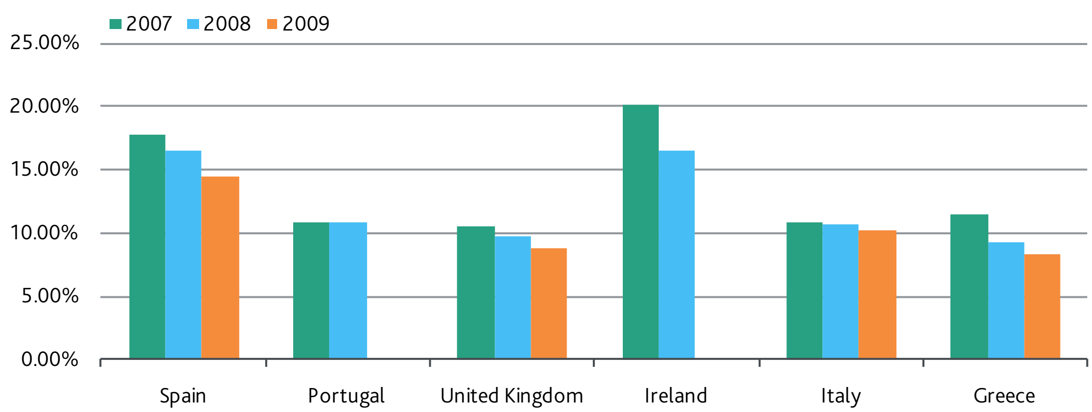
Loan Growth 2005 - 2009



Source: European Central Bank

FIGURE 5

Real Estate % GDP 2007 - 2009



Source: European Commission - Eurostat

Burst real estate bubble poses challenges to Ireland and Spain…

The bursting of the real estate bubbles in both Ireland and Spain was driven by the unsustainably high lending growth (as can be seen in Figure 4, the contribution of the real estate sector to GDP was substantially higher in these countries than in other countries as seen in Figure 5) and has had a considerable impact on these two systems. The speed and size of the decline (with commercial property values down by over 50% in Ireland, and the market in Spain being largely illiquid for many developments) indicates the magnitude of the challenge for both systems.

…while the picture in the UK is a bit more complex, but no less challenging

In the UK, the proportion of real estate lending to GDP has been more in line with that of other countries, reflecting the more diversified nature of the UK economy. Here the challenge is more complicated, with the government having entered the crisis with higher debt levels, and the economy being more harshly impacted due to the much greater reliance on the financial sector. A more severe recession has been prevented by a combination of "quantitative easing", i.e. maintaining excess liquidity, and low interest rates. Any reduction of this excess liquidity or increase in interest rates could destabilise this fragile balance, especially given that the high leverage of households provides little cushion against such a scenario.

In Italy, Portugal and Greece, the lower levels of indebtedness and the lower growth levels would suggest that the countries are facing a more normal cyclical swing in the real estate sector, against which its banking systems should be sufficiently resilient under "normal" circumstances.

Central banks continue to provide funding backstop as markets remain difficult

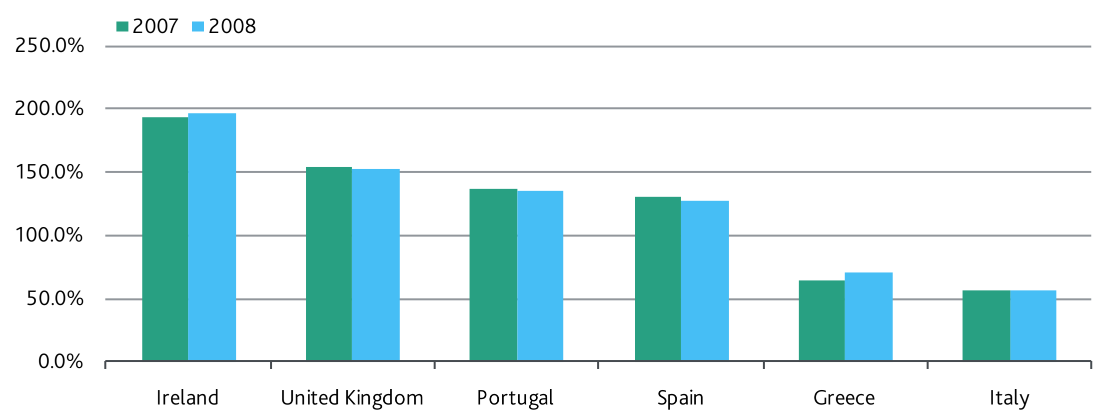
The rapid increase in loan growth also led to a substantially higher reliance on wholesale funding and this was most obvious in Ireland, leading to the introduction of the first sovereign guarantee on bank liabilities. However, the UK banking system also evidenced a high reliance on wholesale funding that dried up in the aftermath of the run on Northern Rock. This, together with the sharp contraction of the residential mortgage market, led to lending growth falling rapidly. Many banks have remained highly dependent on the backstop provided by the European Central Bank and the Bank of England as the market for securitisations, covered bonds and unsecured issues is not always accessible to all banks in these six countries. We note that access to central bank liquidity can ease market concerns about liquidity, but the last two and a half years have also shown that it cannot always offset concerns about the underlying solvency of such banks. In such cases, without the explicit guarantee of a credible authority, it can be much more difficult to ensure confidence of wholesale markets, of the interbank market and ultimately also of depositors.

Households are very vulnerable to increases in interest rates

The increased levels of leverage in the banking systems over recent years was especially marked in Ireland and the UK, but Portugal and Spain also have relatively high levels of household leverage. The ability of households to service these higher debt levels has been aided dramatically in the last two years by the low interest rate environment as the largest outlay is normally mortgage costs. This is especially true in Ireland where the vast majority of lending to households is residential mortgages, whereas in the UK there is a much larger unsecured lending element to fund consumer behaviour that generally does not move directly in line with changes in base rate or libor.

FIGURE 6

Leverage – Gross debt to income ratio of households



Source: European Commission - Eurostat

Any increase in interest rates is likely to affect households especially as the high levels of leverage has reduced the financial flexibility of particularly Irish, UK and Portuguese households. On the other hand, any deleveraging by households could add to the economic pressures especially in those markets where the banking system is also attempting to reduce leverage, such as Ireland and the UK. As with most other factors discussed here where Italy compares quite favourable, the debt levels of Italian households are fairly moderate.

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C. The Response of the State

Recapitalisation and Balance Sheet clean-up are key in Ireland, Spain and the UK

For those systems that have seen the largest deterioration (Ireland, UK, Spain), the need for a clean-up of the bank's balance sheets and recapitalisation of the system has become an issue. The most obvious example is in Ireland where NAMA is acquiring an estimated €80 billion of land and development loans as well as related investment property loans from five Irish banking institutions at a substantial discount. This leads to an upfront loss for the banks and thus leads to a capital requirement that the Irish government has been providing in cases where the banks are unable to raise funds privately. A further positive in the Irish example are the new regulatory capital targets that should further insulate the system in the years ahead and place them in a position to transition to a Basle 3 world.

In the UK, the approach has been different with the introduction of the Asset Protection Scheme (APS) in the first quarter of 2009, originally signed up to by RBS and Lloyds. However, later in the year, Lloyds completed a large capital-raising and pulled out of the APS, leaving only RBS participating. Other banks and building societies have passed the FSA stress tests, but some have needed to raise large amounts of additional capital (Barclays for example).

Delay in its banking sector restructuring could leave Spain exposed to the volatilities of the markets

Spanish savings banks are the most affected by the burst real estate bubble in that country. The government has earmarked up to €100 billion in its Funds for the Restructuring of the Banking Sector ("FROB") to recapitalise these banks and is pushing for a sector consolidation of around one-third. So far, the consolidation is progressing, albeit at a slower pace than envisaged by the Spanish authorities, and the cajas have been very reluctant up until now to tap the funds provided by the FROB.

Given that only approximately €12 billion of the FROB has been funded so far, the Spanish government intends to fund further calls on the FROB by accessing the capital markets when required. This could create a difficult interdependence between the sovereign and the banks: if concerns about the country's banking system or the concerns about Greece spill over into the credit profile of the sovereign, this could give the recapitalisation of the banks renewed urgency. However, the government could then be confronted with greater difficulty accessing the markets – or at least with much more expensive funding.

Fiscal tightening likely to impact banks, especially in Greece, Portugal, Ireland, Spain and in the UK

The tightening of fiscal conditions is likely to be transmitted to the banks through lower profitability and deteriorating asset quality as disposable income declines and demand for loans diminishes. The increase in unemployment that is likely to follow on from austerity packages is also likely to lead to greater losses on banks' loan portfolios. The impact of this is likely to be felt the most in Greece given the scope of the package that will be a prerequisite for the support from the European Union and the IMF. However, we believe that the impact could potentially also be felt in Portugal, Spain, and in the UK after the upcoming elections, and indeed it is already being felt in Ireland where the tightening began a little earlier.

Italy more sheltered, but not immune

Despite reporting similarly high government deficit levels as the other countries, the Italian government has so far been under less pressure to consolidate its finances, which means that Italian banks are currently expected to be less impacted. Furthermore, there are many reasons why Italy differs from Greece and Portugal – such as its significantly larger economy, its founding member status of the EU placing it at the core of the European Union, and its more competitive industrial base, especially in the north of the country. However, its fiscal position does not immunise it against market concerns, which could also impact its banking system that – apart from its largest players – is primarily domestic-focused and not overly strong.

D. Sovereign Strength and Economic Performance Are Important Inputs Into Banking System Strength

As shown in Figure 7, the ratings of the six governments examined in this report range widely from the Aaa (stable outlook) of Spain and the UK, to the A3 (on review for possible downgrade) of Greece. Additionally, the Moody's sovereign teams' 2010 GDP forecasts also differ widely from the slight positive expectation in Italy and the UK, to a considerable decline in Greece as the austerity package takes effect. Given the rapid decline in economic output in 2009 in the six countries, we believe that GDP development will over the medium term remain an important driver of the health of the banking systems.

FIGURE 7

Moody's Sovereign Ratings

COUNTRY	GOVERNMENT BOND RATING	OUTLOOK	REAL GDP GROWTH 2009 (EST)	REAL GDP GROWTH 2010 (FOR) *
Spain	Aaa	Stable	-3.70%	-0.80%
United Kingdom	Aaa	Stable	-4.70%	0.50%
Ireland	Aa1	Negative	-7.00%	-1.00%
Italy	Aa2	Stable	-4.70%	1.00%
Portugal	Aa2	Rating Under Review	-2.60%	0.70%
Greece	A3	Rating Under Review	-2.00%	-4.00%

*Source: Moody's Investors Service

At the start of the crisis, Ireland, the UK and Spain all benefited from high levels of sovereign creditworthiness and this has enabled these countries to bail out their banking systems with a relatively little impact on their credit ratings (to date only Ireland has lost its Aaa rating and is now rated Aa1 with a negative outlook.) However, at the other end of the spectrum, and within the same period, Greece has been downgraded from A1 to A3 (on review for possible downgrade) with the potential for a further multi-notch downgrade, and Portugal's Aa2 rating has been placed on review for possible downgrade. Market pressure on the Greek government has also affected Greek banks as market participants are no longer prepared to roll over Greek bank or sovereign debt. Greek banks have therefore become almost totally reliant on the ECB for wholesale funding. This weakness, together with the likely impact of the expected austerity package, led to the recent downgrades in the BFSRs of the Greek banks.

There has been little impact of the banking crisis in Italy, and the Greek sovereign issue has also, to date, not had a major impact on Italian banks. However, the potential for a "Mediterranean" contagion in investors' perception, leading to pressure on the banking systems remains our biggest concern, although we believe that the likelihood of this happening to such an extent that the whole system is affected is low at this stage.

However, in Portugal we are already seeing the cost of funding increase and CDS spreads widen as a direct result of the issues in Greece. This has the potential to negatively impact the banking sector, although again this is through pressure on the sovereign rather than as a direct consequence of banking weaknesses.

Country by Country Summary

Ireland – Ireland was one of the first countries to be affected by the abrupt bursting of the real estate bubble. But it has also been among the first to take decisive actions, first by guaranteeing banks' debt, and then by implementing the restructuring and recapitalisation plan, combined with very severe austerity packages imposed by the government. The government and the banks now have to execute the plans and hope that the decisiveness and large acceptance of the austerity measures by the population will see them emerging stronger, albeit smaller, at the end of this process.

UK – With the economy facing challenges, the banking sector remains vulnerable: the highly leveraged economy is benefiting greatly from the benign interest rate environment, but the threat of a double-dip recession (in case of a fiscal tightening that is too harsh) or increased funding costs for the banks and the sovereign (in the opposite case) remain. Many banks and building societies are also still vulnerable to the downside scenarios, especially in their domestic retail and real estate exposures. Moreover, a deterioration in unemployment or higher interest rates are likely to further impact asset quality.

Spain – Liquidity could be the key: wholesale market access requires confidence in banks' solvency and currently this confidence is lacking. Banks will therefore remain dependent on ECB funding and a robust deposit base. Many cajas are benefiting from a low degree of cross-border business and are therefore sheltered from international market pressure. Provided that the system remains sheltered, the key question will be whether profitability will be sufficiently resilient to absorb asset impairments over next few years.

Portugal – Will the Mediterranean current wash Greek trouble onto Portugal's Atlantic shores? With a little help from the government, the domestic banking system should be adequately prepared for domestic economic cyclicality; however, the risk of an external shock – almost certainly from the contagion from sovereign issues in Greece – could impact the banking sector, which in itself is not very strong, has a high reliance on wholesale funds and quite substantial cross-border activities. The banks' ratings have been placed under review for possible downgrade to examine the degree of vulnerability to such developments.

Italy with all its vulnerability has remained remarkably resilient so far: However, the traditionally low-growth economy and relatively weak banking system is well positioned to fend off cyclical challenges. The major risk (albeit less likely in our view) is that of a "Mediterranean" contagion in investors' perception, which could exert indirect pressure on the banking system.

Greece is now in the middle of its own crisis that could impact other countries. The necessary tight austerity measures that accompany the recently agreed IMF and European Union support package will have a direct impact on the economy and on the banking sector, and funding will remain under pressure despite expectation of ECB support.

Overall, each of the six banking systems examined in this report faces different challenges, but the contagion risk could dilute these differences and impose very real, common threats on all of them.

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