DEBT CAPITAL MARKETS

FINANCIAL TIMES **SPECIAL REPORT** | Tuesday October 25 2011

www.ft.com/debt-capital-markets-2011 | twitter.com/ftreports

Crisis is a game with no winner

Another round of the financial equivalent of pass the parcel is about to begin, report **Richard Milne** and **Michael MacKenzie**

The sovereign debt crisis may seem to have little to do with children's party games. But for some, the rolling debt crises of the past decade bear more than a little resemblance to pass the parcel.

In that childhood classic, players pass around the parcel until the music stops, at which point they have to take off a layer of wrapping paper. The winner is the person to remove the final layer and reveal the prize within.

In the financial equivalent, the debt parcel in the developed world has been passed from player to player in recent years. The first holders were companies and they suffered the first big debt crisis following the dotcom bubble and Enron scandal. But the debt was quickly passed on to consumers and banks, and, after the financial crisis, to governments.

No prize awaits the final player in this game. Nonetheless, in the past few years it has looked like there could be another round to go: governments seem keen to pass the debt burden on to their own central banks.

Financial Markets series

Recent weeks have provided support for the theory. The Bank of England has launched a second round of buying government bonds with newly created money, known as quantitative easing, while the US Federal Reserve has begun a new policy called Operation Twist only months after finishing its own second attempt at quantitative easing, known as QE2. Even the European Central Bank, disdainful of the idea of monetising debt, has been buying the bonds of Italy and Spain – the third- and fourth-largest economies in the eurozone.

"We've got the super debt cycle still going on and the debt is still being passed round. Where does it end? Is there a limit?" asks Mike Turner, head of asset allocation at Aberdeen Asset Management.

The moves by central banks have resulted in big expansions of their balance sheets – those of the Fed and Bank of England have tripled, while the ECB's has almost doubled. But they have also had a deep impact on bond markets.

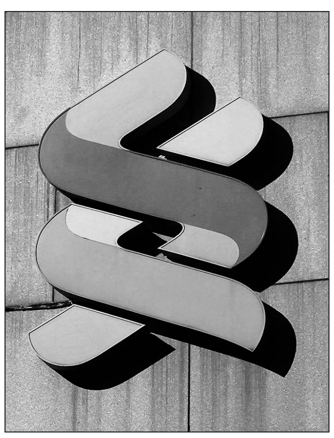
The three main government bond yields used as reference points by investors globally – 10-year US Treasuries, UK gilts and German Bunds – all hit multi-decade lows in the past few weeks. Central bank action was only partly to blame, with intense investor worries about growth also weighing heavy.

Improving that economic outlook is the main justification for QE in the US and UK. The Fed's Operation Twist is the fourth extraordinary policy measure

Continued on Page 3

Debt Capital Markets

In This Issue



Front Page Illustration MEESON

Contributors

Richard Milne
Capital Markets Editor

Michael MacKenzie
US Markets Editor

Ben McLannahan
Lex Writer, Asia

Tracy Alloway
David Oakley
Robin Wigglesworth
Capital Markets Reporters

Adam Jezard
Commissioning Editor

Steven Bird
Designer

Andy Mears
Picture Editor

For advertising, contact:
Ceri Williams on +44 (0)20 7873 6321,
email: ceri.williams@ft.com
or your usual representative

All FT Reports are available on FT.com.

Follow us on twitter at twitter.com/ft.reports

It is time to rethink where cash is safest

After the crisis

Investors are beginning to look beyond government debt, writes **Richard Milne**

Havens for investors used to be easy to find. US and German government debt and the US dollar and Swiss franc were the classic refuges.

But the financial crisis and its aftermath have upset the calculation.

In particular, government debt is now no longer seen as entirely risk-free and investors are beginning to look at corporate debt as perhaps safer, something that would have been heresy until very recently.

"Since 2008, companies are generally safer," says Didier Duret, chief investment officer of ABN Amro Private Bank.

"They are cash-rich," he explains. "They have the money that states don't have. We need to undertake a total rethink of the idea of safe havens."

The eurozone crisis is also partly to blame for the current situation.

The rapid deterioration in the borrowing costs of countries such as Greece, Ireland and even Italy has shattered the notion that all countries in the developed world are without risk.

Investors now have to confront the idea of credit risk – or the chance of default – for all countries, whereas, traditionally, they only had to worry about interest risk.

The summer downgrade of the US by Standard & Poor's from its top triple A rating demonstrated how even the biggest governments are affected.

It was not meant to be like that.

The risk-free nature of government debt is hardwired into global banking and insurance regulations, allowing financial institutions not to set any capital against sovereign debt. Corporate debt is much more onerous to hold.

Nonetheless, many investors are starting to see companies as being a safer bet than governments.

Part of that stems from the debt pass-the-parcel game of recent years (*see page 1*).

Companies have largely learnt the lessons of their own brush with big debt burdens at the turn of the century and now have their strongest balance sheets for decades. Their cash piles are vast, reaching $2,000bn alone for US companies.

It is, then, little wonder that investors have flocked to corporate debt. A company's balance sheet is seen as easy to understand, whereas those of banks and governments are viewed as non-transparent at best by many.

"Bondholders can understand corporate risk," says Martin Egan, global head of primary markets at BNP Paribas.

"The companies produce things that you eat, drink or drive," Mr Egan continues. "Investors have very heavily favoured corporate risk because they can see the upside, but also quantify the downside. All that has been less clear for financial and sovereigns."

Italy and Spain offer some of the best examples of the phenomenon.

> 'Companies are cash rich. They have the money that states don't'

A bond coming due in 2013 from Telefónica, the Spanish telecoms company with significant operations in the UK and elsewhere, yielded 2.89 per cent in mid-October. A Spanish two-year government bond had a yield of 3.68 per cent.

Similarly, Eni, the Italian oil and gas company, had a 2013 bond with a yield of 2.39 per cent while the nation's sovereign two-year yields were 4.29 per cent.

"There is an opportunity for companies there to be better credits or investments than the underlying government paper," says Paul Griffiths, head of fixed income at Aberdeen Asset Management.

He adds that the key is to ensure the company is not reliant on one country, particularly where its headquarters are, for too much of its revenues.

For instance, Spanish construction companies might have gorged on domestic work in the run-up to the crisis, but now the likes of FCC are involved in projects from Singapore to Mexico.

"The big global names that are not beholden to any one country have the ability to step away from what happens in their home country," explains Mr Griffiths.

But the idea that companies are safer than countries poses difficulties. Some are theoretical. Most countries can still, normally, print money, unlike businesses.

But, of course, many people see it as one of the weaknesses of the eurozone that individual countries can no longer print money.

This means that the "companies as safe haven" doctrine might be stronger in the single currency area.

A second attribute of countries is that they have the power to impose taxation and, indeed, can subject businesses to ever-increasing levies. An example can be found in European utility companies, which have been hit by new taxes.

But perhaps the biggest objection comes from recent reality.

As investors pushed down US Treasury yields to their lowest since 1946 and German Bunds to the lowest ever, corporate credit started to sell off.

Some indices reached as a big a distance from government yields as they did after the collapse of Lehman Brothers, the investment bank in September 2008.

For the right company – in the wrong country – the idea that it might be a safer bet than the debt of its government is no longer absurd.

However, there are also many other less secure companies still out there, which means investors will need to be careful which ones they choose before writing off governments too quickly.

A Telefónica bond yielded 2.89% this month Bloomberg

Crisis plays out as a game without a winner

Continued from Page 1

introduced since the financial crisis, after purchases of mortgage debt, QE1 and QE2. The goal of Operation Twist is to spark a sustained drop in long-term interest rates and thus stimulate consumer and business borrowing.

But many in the investment community are sceptical. "As yet, there are few signs that further accommodation has or can have a meaningful effect on output growth," says Guy LeBas, chief fixed-income strategist at Janney Montgomery Scott.

"Instead, we view this latest policy as an attempt on the part of the Fed to bluff its way to better economic conditions by persuading consumers and the markets that low rates will have a big impact, despite little evidence."

Their extraordinary actions mean central banks are facing increasing criticism. In the US, this is largely coming from the Republican Party, while in Europe the main opposition emanates from Germany, which has a conservative central banking tradition.

Didier Duret, chief investment officer at ABN Amro Private Bank in Geneva, alludes to this when he says: "Central banks have reached the limits of their own credibility."

He adds that the role of central banks is to be boring: "We will recognise the end of the crisis when central banks become boring again."

Despite the historically low level of yields – even after a sharp rise in the first few weeks of October – investors remain divided over the outlook for bond markets.

One school of thought says that the likely route out of the debt crisis will be through inflation.

In that case, 10-year government bonds of 2-3 per cent offer poor value. But others argue that, however reasonable this view seems, other forces are at work.

"It is not a question of good value; it's about a place to hide. Probably, bond yields are atrocious value compared to inflation, but they will benefit if trouble flares up in Europe again," says Mr Turner.

For some, this means yields could fall to even deeper lows. Shahid Ikram, head of sovereigns at Aviva Investors, says: "Who is to say that yields won't be down at 1 or 1.5 per cent? If I were to look at the economic fundamentals and not look at the yields, I would buy bonds."

In the US, there is a feeling that the Fed's buying of Treasury debt is distorting the signals that are usually sent by bond yields.

Many have pointed to the Japanese experience, where once government bond yields fell below 2 per cent in the 1990s they have only extremely rarely moved above them.

> 'Bond yields are probably atrocious value but they will benefit if trouble flares up'

"Investors focus on market signals and when they saw a 10-year at 2 per cent, the fear was that it must be signalling that a recession is imminent," says Jim Paulsen, chief investment strategist at Wells Capital Management.

"The Treasury market is heavily distorted by the Fed and low yields do not mean the US is about to follow Japan."

Jason Pride, director of investment strategy at Glenmede, calls the investing landscape that results from expectations of stagnant growth and low yields an "upside-down" environment that could persist for some time.

"You must reassess your investments and you are better off taking a more activist approach," Mr Pride says.

For bankers involved in debt capital market deals, the sovereign debt crisis has proved to be a huge disruption.

European markets in particular have been all but closed several times in the past 18 months.

Martin Egan, global head of primary markets at BNP Paribas, says: "We are working in an environment with vast amounts of headline risk."

But the crisis is also masking a shift in corporate funding, especially in Europe.

While banks face up to regulation and shrink their balance sheets, more and more companies are looking at raising money by issuing bonds in the capital markets rather than through loans.

Some argue that the stresses resulting from the debt crisis could even accelerate the process, as banks wonder for how much longer they can lend to their corporate customers at lower rates than they can borrow at themselves.

"Every corporate treasurer around the globe will want to retain flexibility and have some loans, but more and more debt from capital markets . . . " says Mr Egan. "We will be working in a capital and liquidity constrained environment, and how that evolves will be critical to how companies borrow. It won't make life straightforward."

Martin Egan: We are working in an environment with vast amounts of headline risk'

Debt Capital Markets

Radical move could help end eurozone problems

A statue outside the European parliament holds the euro sign aloft but the future of the eurozone is uncertain
Bloomberg

Monetary union

European common bonds potentially offer a solution to the crisis, says **David Oakley**

The eurozone government bond markets have been turned upside down since the financial crisis first erupted in August 2007.

And they could suffer even more upheavals, as bankers press policymakers to come up with what could prove to be the key to the survival of the eurozone: common bonds.

Peter Schaffrik, head of European rates strategy at RBC Capital Markets, says: "The whole structure of the eurozone government bond markets has changed, but there may need to be more radical measures to end this crisis. European common bonds are a possible answer."

Although Mr Schaffrik thinks it may take time to convince Germany and other northern eurozone members that common bonds could work, there is a growing view among many bankers that it may be the only way of allowing some countries to access the markets.

Many investors say they would happily buy a common bond that was issued on behalf of all 17 members of the euro.

On the other hand, they say they are unlikely to buy the debt of the small peripheral countries Greece, Ireland and Portugal while their economies struggle. Some funds are reluctant to buy the debt of Spain and Italy, too.

Certainly, the debt of the peripheral economies is unlikely to be seen as risk-free, which would mean that there was minimal risk of their bonds defaulting for a long time.

Indeed, Greek government bonds are no longer classified as such by some strategists. Technically, the debt of a sovereign should be safe, offer low yields, and have a liquid, stable market – characteristics that no longer apply to Athens's debt. One 10-year bond is now trading at yields above 150 per cent, so far off the scale that even yields of some of the shakiest emerging markets such as Argentina and Venezuela are lower.

The same applies to government debt in Portugal and Ireland, although not quite in the extreme way of Greece. These peripheral economies, too, no longer offer risk-free debt.

As these peripheral bond yields have lurched higher, so the bond yields of the safest economies, such as Germany, have plumbed new lows as investors have sought Berlin's debt as a haven.

In effect, the fall in German yields – as the peripheral's borrowing costs have risen – is equally damaging for the eurozone as it has undermined competitiveness in the weaker economies, where borrowing costs and, therefore, costs for manufacturers are much higher.

A common eurozone bond would help to provide a more level playing field and, in theory, lead to a market that could challenge the might of US Treasuries, instruments that are issued on the biggest and most liquid bond market in the world.

It could also pave the way to closer fiscal union, which many investors think is essential for the eurozone to survive.

However, the pitfalls are obvious. Because common bonds would include the weaker countries, the bigger, richer economies, such as Germany, the Netherlands, Austria and Finland, would have to pay more to borrow, as the yields of a common eurozone bond would probably be higher than their domestic debt.

Gary Jenkins, head of fixed income at Evolution Securities, says: "Common eurozone bonds would offer the solution for many of the problems in the region, particularly if it was made clear to the more profligate countries that they would only be able to be part of the process with lower debt levels.

"But will Germany or other northern European countries be prepared to give up their competitive advantage? When that happens, we will see the next stage of the fiscal integration process in the eurozone."

For now, uncertainty is the only constant in the eurozone debt markets.

In fact, one of the key questions on the lips of many investment fund managers is: Will the eurozone survive in its present form? Some seriously wonder whether Greece can continue for long inside the 17-nation club, as the price it has to pay in terms of austerity is so high.

Should Greece leave the eurozone, however, the repercussions will be extensive, not just for Athens's bonds, but for the markets of the entire region.

> 'Will Germany or other northern European countries be prepared to give up their competitive advantage?'

It would lead to banks and investment funds with Greek debt on their books suffering big losses, which would in turn hit sentiment in all government bond markets, quite probably including that of Germany.

This is why bankers say the common bond option may eventually appeal to the Germans.

Don Smith, economist at Icap, says: "Germany has very low borrowing costs. They may eventually consider it is worth paying a higher price to borrow through common issuance, if they think the alternative is the break-up of the euro, as that would be very damaging for their economy."

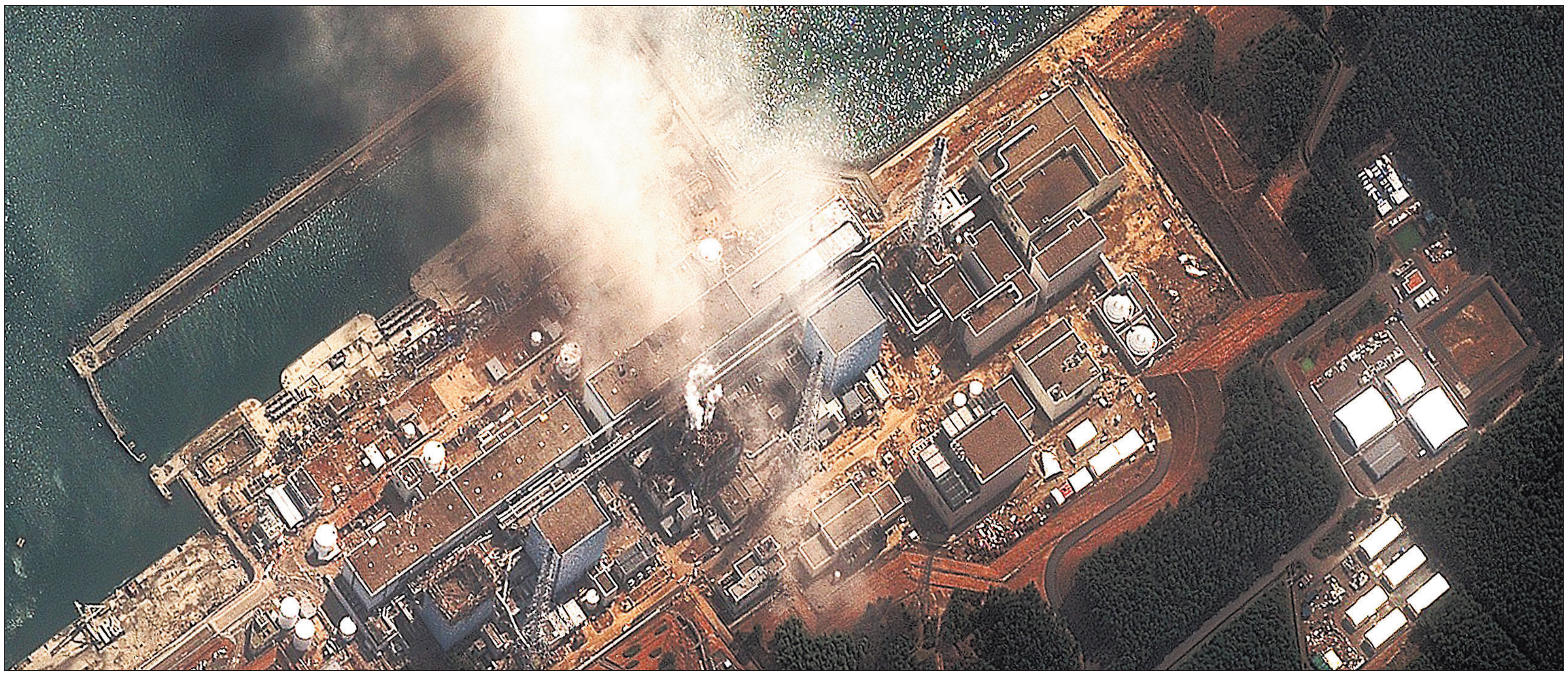
ON FT.COM

Retail investors have become important for leveraged loans
www.ft.com/debt-capital-markets-2011

Utilities suffer but demand grows overall

Japan focus

Power companies have fallen out of favour, writes Ben McLannahan



Tepco's Fukushima nuclear plant was hit by the tsunami in March. Most electrical utilities' bonds have fallen out of favour following the disaster Bloomberg

Any review of Japanese debt capital market activity normally starts and ends with Tepco.

The electric utility serving 29m consumers in the area surrounding Tokyo is easily the nation's biggest corporate issuer. It has Y4,725bn ($61.3bn) in outstanding corporate bonds, 7 per cent of national total.

But since the tsunami swept over the company's Fukushima nuclear plant in March, it – with eight of the other nine electric utilities serving Japan's regions – has been frozen out of the public market, unable to raise any finance except bank loans or short-term commercial paper, both at significant premiums.

Only Okinawa Electric, the smallest, and with no exposure to nuclear power, has done a bond deal. Kansai and Kyushu both launched offers in June, but were forced to cancel after poor demand.

If the costs of shutting down reactors and sourcing replacement fossil fuels were not bad enough, there is the growing fear that energy policy will come down hard on these debt-laden operators.

Chubu, Kyushu and Kansai Electric are three of the five worst-performing credit default swaps in the world so far this year, up between about 750 and 950 per cent. The worst is Tepco, which is up almost 4,000 per cent.

Reiko Hayashi, Tokyo-based head of debt capital markets at Bank of America Merrill Lynch, says: "With so many uncertainties still to be clarified, people say it is too early to discuss restarting public borrowing programmes."

A cumulative 13 per cent of corporate bond supply, in other words, has been suspended indefinitely.

And yet demand has remained more or less constant. At Japan's banks, for example, which hold half of the nation's corporate bonds, deposits exceeded loans by a record Y166,700bn in June. "The banks are extremely cash-rich," says Seiichiro Miyaoka, head of debt capital markets at UBS in Tokyo. "They need to invest in something."

That big imbalance had two main effects. First is a general flight to safety, which has benefited central government bonds in general and municipal bonds (munis) in particular. Before the nuclear incident, Japanese government bonds (JGB) were not short of support; yields have steadily fallen since.

Ten-year JGB yields slid to 1.02 per cent in the third quarter from 1.13 per cent in the second. "Some institutions have increased allocations for JGBs as they sold electric utilities," notes Tomoyuki Okuzaki, Tokyo-based deputy general manager of debt capital markets at Mitsubishi UFG Morgan Stanley Securities.

Munis have proved popular substitutes for Tepco: highly rated, backed by an assumption of central government support, but with a little extra yield.

> 'Underwriters are encouraging corporations to come to the market to enjoy favourable financing conditions'

The key word is "little": Tokyo Metropolitan Government, for example, paid a record-low 2 basis points over sovereign debt on Y20bn of seven-year, 0.58 per cent bonds issued this month.

Ayumu Fukazawa, head of fixed-income at Credit Suisse in Tokyo, says: "Because of a simple lack of supply, many investors rushed to buy [them]." He adds that 2 basis points is equivalent to a "typical intraday move" in a 10-year Japanese government bond.

Second, there has been a broadening of participation, on both the investor and issuer side. As quoted prices for electric utilities bonds have fallen, retail investors have been tempted to snap them up. If Japan Credit Rating Agency were to follow the cue of the other big domestic agency, Rating and Investment Information, and downgrade Tepco from single-A to triple-B, it would trigger more liquidation from institutions, even at big discounts.

More significant, though, is the renewed interest from borrowers. "Underwriters are encouraging corporations to come to the market, to enjoy favourable financing conditions," says Ms Hayashi of BofA. Some, such as Mori Seiki, the Osaka-based machine-tool manufacturer, which issued Y30bn of three- and five-year bonds, have dabbled in the market for the first time. Others, including Nichirei (cold storage) and Dainippon Screen (semiconductor cleaning) returned after multiyear absences.

Foreigners are weighing in, too. The volume of Samurai bonds (yen bonds issued by non-Japanese entities) sold in the first nine months was up almost a quarter from a year earlier, according to Dealogic, reaching $21bn – a whisker away from the record $21.8bn haul of 2008.

In July, National Bank of Abu Dhabi, the United Arab Emirates' second-biggest bank by assets, sold the Gulf region's first Samurai; issuers from Korea and Mexico have made debuts, or have made plans to do so.

"We're seeing a lot of interest from a wide range of countries and governments, as they seek yen funding at attractive rates," says Mr Okuzaki.

The result is that the market has withstood the loss of its cornerstone issuers. Corporate volumes held steady at $62bn, year-on-year, in the first nine months, while debt capital market volumes were up 6 per cent, at $230bn.

This remains a relatively small, thinly populated market, where individual deals are mostly about Y15bn ($200m), well short of European or US benchmarks. But pipelines look strong, and primary spreads continue to tighten. For investment banks, amid patchy merger volumes and a collapse of primary equity deals, DCM desks are a rare bright spot amid the gloom.

Debt Capital Markets

Big companies can borrow while small ones struggle

Corporate outlook

Global woes are hurting debt sales, writes **Robin Wigglesworth**

Protesters against austerity in Greece. The eurozone crisis has rattled investors EPA

Corporate bond sales surged after the financial crisis of 2008, as stricken banks cut lending, forcing companies to turn to debt markets for financing, and investors poured money into fixed-income funds.

After dipping by 5 per cent to $777bn in 2008, global issuance of investment grade and high-yield debt by non-financial companies exploded to $1,415bn in 2009 and $1,160bn last year, according `to Thomson Reuters' data.

This summer's financial turmoil, however – driven by mounting concerns over the eurozone's debilitating debt crisis and signs that global economic growth is faltering – has rattled both investors and companies, severely crimping debt sales.

Global issuance fell to $206bn in the third quarter, the lowest since late 2008. This has resulted in a dislocated and increasingly two-tiered market, where large, higher-rated companies can borrow cheaply, but riskier, smaller non-investment grade entities struggle.

Thanks largely to rock-bottom central bank interest rates in much of the developed world and an investor flight to safety, the average fixed-rate borrowing costs for investment grade companies fell to 4.23 per cent in the third quarter, down from 4.36 per cent in the preceding three months, according to Thomson Reuters.

"Companies are a lot less worried now than they were in 2008," says Melanie Czarra, head of European primary debt markets at Mizuho International, an investment bank. "They have much less leverage, and, generally, a lot of cash on balance sheets."

Issuance has noticeably dipped, but the $206bn of debt sales in the third quarter comfortably outpaced the lows of 2008, and was better than most of the three-month periods that preceded the financial crisis. Some larger multinationals have been able to borrow at record low rates.

"The debt markets, particularly in the US, have continued to remain open, even at times of stress," says Mark Lewellen, European head of corporate debt capital markets at Barclays Capital. "Investors clearly view the stronger corporates as a safe haven. Even at a time when global growth is being questioned, we haven't seen a huge impact on demand for the better quality investment grade corporate bonds."

For high-yield corporate debt – junk bonds – the picture is murkier.

The average coupon for fixed-rate junk bonds climbed almost 100 basis points to 9.15 per cent in the third quarter, and issuance collapsed.

After three straight quarters of global high yield issuance topping $100bn, junk bond sales fell 73 per cent to $29bn in the three months to the end of September.

"High yield is clearly vulnerable to the macroeconomic environment," says Anthony Robertson, head of high yield at BlueBay, a debt-focused asset manager in London. "Global growth and the eurozone crisis are two pretty big risks, and the market is pricing in a recession now."

Stresses in the riskier end of the corporate credit markets are particularly apparent in Europe. Markit's crossover index, which tracks the credit-default swaps on European junk bonds, rose to almost 900 basis points in early October, and even the data provider's main index, which tracks safer investment grade debt, has risen.

"Investors are increasingly differentiating, even among investment grade names," says Matthias Minor, managing director at Royal Bank of Scotland. "In Europe, there is a differentiation between core and peripheral countries, with the latter still finding markets challenging."

While European companies – whether investment grade or junk – are largely well funded, turbulent markets could spell trouble for some weaker or overleveraged companies.

> 'Volatility is probably not going to abate but potential returns look great'

"There's no major bump on the horizon for corporates," says James Douglas, a debt advisory partner at Deloitte. "But the refinancing problems will be more acute in the private equity-owned space, where there are a lot of overleveraged companies. That still needs to be tackled."

Nonetheless, bankers are cautiously optimistic on the outlook for corporate debt. While billions of dollars and euros have been yanked out of high-yield funds in particular, asset managers are still sitting on healthy cash buffers, and the number of defaults remain subdued.

Although corporate failures are likely to start rising again, particularly if economies slip back into recession, bankers and analysts insist market indices and bond spreads are indicating an unrealistic amount of economic distress and corporate failures.

"It feels like the debt markets are overemphasising the problems," says a senior banker. "Investors should realise how cheap things are. Volatility probably isn't going to abate, but potential returns look great."

Primary activity is likely to remain subdued for the rest of the year as most companies across the world have taken care of near-term funding needs and investors avoid risky bets.

But bankers are hopeful the combination of largely healthy companies, ample investor firepower and a continuing deleveraging process by banks will cause corporate bond sales to resume their upward trajectory next year.

"Activity usually slows towards the end of the year as investors close their books, but we could come back quicker than many expect in the first quarter," says Jean-Marc Mercier, global head of debt syndicate at HSBC.

Agencies Responding to criticism

In the wake of the financial crisis, the big credit rating agencies face a hard time regaining credibility.

Ratings are hard-wired into the financial system and serve a critical role for investors, who often have mandates that stipulate they can only own debt of a certain grade.

Ratings cuts can trigger sales of certain securities, underscoring the agencies' powerful role.

Jason Pride, director of investment strategy at Glenmede, says: "We use our own analytics, but we do look at ratings; you have to take them into account."

Attention has recently focused on sovereign rating downgrades for eurozone countries, notably Italy and Spain, along with banks exposed to their debt.

The relevance of rating actions, particularly for a country such as the US, has also been questioned by markets and investors as downgrades feed volatility.

Standard & Poor's downgraded the US from triple A status in August, after which the yield on the benchmark US Treasury 10-year note dropped from 3.5 per cent to a 65 year low of 1.77 per cent.

That reaction underlines how big agencies such as S&P, Moody's and Fitch Ratings struggle when it comes to assigning and changing debt ratings for companies and countries.

Richard Cantor, chief credit officer at Moody's, says: "[We agencies] get criticised for our rating decisions, which is an inevitable consequence if one issues independent opinions."

This year, Moody's published a report about the usefulness of ratings. While it stressed the important role of ratings, it pointed out that they are only one measure of risk.

The big agencies were also criticised for their triple A ratings of mortgage-related securities that formed collateralised debt obligations ahead of the financial crisis in 2008.

A US Senate inquiry later found that the original ratings on many CDOs, were "deeply flawed".

Late last month S&P was notified by the US Securities & Exchange Commission (SEC) that it could face civil charges alleging it violated federal securities laws in connection with its rating of a structured finance vehicle before the crisis. S&P says it is co-operating with the SEC.

John Olert, chief credit officer at Fitch, says: "No one can argue that the criticism is not deserved. We have made changes. Lesson learnt is a major theme and I think if we had communicated better across groups, the rating decisions would have been different."

The big rating agencies have all sought to improve the transparency of the methodology used in rating debt. Lawmakers want to see ratings become more transparent, and also address conflicts of interests at the agencies.

Mr Cantor says Moody's has "adopted criteria that have drastically limited our participation in the resecuritisation market. We no longer rate new transactions in a number of sectors, such as second-lien residential mortgage-backed securities (RMBS), structured investment vehicles, and structured finance CDOs."

Fitch implemented a moratorium on rating CDOs in November 2007 and in 2008 it held discussions with investors, dealers and regulators about evolving Fitch's approach to analysing risk in the sector.

"After the financial crisis, S&P made many changes, including significant enhancements to the criteria used to rate US RMBS and CDOs," says Ed Sweeney, the agency's director of corporate communications. "Overall, the changes make it more difficult for these securities to receive high ratings."

But for all their efforts, the agencies are still found wanting. The SEC recently issued a report on the 10 registered credit rating firms that was critical of their performance.

A large criticism of the rating agency model is the perceived "conflict of interest", whereby they are paid by the issuer of debt for a rating. The agencies collectively contend that is not the case.

"Compensation for people working in credit policy has nothing to do with the firm's financial operating performance," says Mr Cantor. "We completely separated commercial and rating activities."

Michael MacKenzie

Richard Cantor: separated activities

Confronting the future of funding: Standard Chartered is one of the few financial institutions that have managed to issue senior debt deals in recent weeks AP

Investors face bail-in challenge

Bank funding

Bondholders could be forced to accept higher losses if institutions fail, says **Tracy Alloway**

It forms the bulk of European bank financing, and it is the biggest tool in financial funding kits, but so-called senior unsecured debt has been rocked by a series of recent challenges.

Chief among them is the possibility of bail-ins – a way for some European Union regulators to force losses on to bondholders who had previously been bailed out along with weakened banks at a hefty cost to taxpayers. Denmark and Germany, for example, have already adopted such regimes and under European Union plans more may join them.

Meanwhile, the intensification of the eurozone crisis has raised fears that bail-ins could get their first chance to spring into action as European banks face an unknown quantum of losses from sovereign defaults or restructurings.

"This year started off with an announcement from the European Union about bail-ins," says Vinod Vasan, head of European financial institutions debt capital markets at Deutsche Bank. "It was almost thematic in terms of setting the tone for the rest of the year."

From that moment on, Mr Vasan says, the bank funding market was in the spotlight, with senior unsecured coming under the most under pressure. In fact, Europe managed to go an unprecedented near-three months without a single unsecured deal this summer, with Deutsche Bank finally breaking the dearth of issuance in late September.

"There are reasons for senior bonds to reprice," says Simon Chester, portfolio manager for American Century Investments. "But if you look at where seniors are trading, particularly for stronger institutions, there are some opportunities there."

Still, even while some investors are favouring banks' senior bonds, many have rushed to switch into another type of bank debt, one secured by the banks' own assets. Nowhere is this switch more apparent than in the issuance of covered bonds.

Unlike senior unsecured debt, which is not backed by its own specific pool of collateral, covered bonds are overcollateralised with assets that are hived off from the rest of an issuing bank's balance sheet. That may provide an extra cushion of safety for bank debt investors who are nervous about the prospect of losses.

With senior unsecured on the back foot, Europe's banks issued €195bn ($269bn) worth of covered debt in the first nine months of the year, compared with €287bn of senior unsecured issuance. Here was a product that was not just limited to stronger banks, but one which was considered so safe by investors it could still be issued by weaker names.

In some cases the covered bonds issued by banks situated in the eurozone's peripheral members have been trading at lower spreads than government bonds.

> 'If you look at where seniors are trading, there are some opportunities, particularly for stronger institutions'

"Any covered type of product, whether it be asset-backed securities or covered bonds, has now been settled upon as the preferred way to invest in financial names," says Matthew Pass, head of European financial institutions debt for RBC Capital Markets.

Ironically, the spur in covered bond issuance could herald more trouble for senior unsecured investors, who rank below secured creditors in the event of a bank's failure. Because the bonds are typically overcollateralised with relatively high-quality mortgages and public sector loans, they can effectively take good assets away from senior unsecured creditors.

"You are really using your best quality assets for covered bonds," notes Sandeep Agarwal, head of financial institutions debt capital markets at Credit Suisse. "But eventually, their use will need to be limited so as to balance credit worthiness for senior unsecured creditors."

Because of this there are regulatory limits on the amount of secured debt banks are allowed to sell, which vary from country to country in Europe. Rating agencies, too, may start to downgrade a bank's senior unsecured credit ratings once they feel its balance sheet is overencumbered. That, say some analysts, may be starting to happen for banks that have been locked out of senior unsecured markets this year, relying on covered bonds for funding.

It is not all doom and gloom for senior unsecured. Some market participants suggest the trend towards forcing banks to hold more higher-quality capital, with an emphasis on elements such as loss-absorbing common equity, could provide an added layer of protection for senior unsecured investors, so making the debt more appealing, particularly to already strong names.

Meanwhile, as European authorities have moved towards a programme of bank recapitalisation in recent weeks, a number of banks have managed to issue senior deals, including Rabobank, Standard Chartered and Svenska Handelsbanken. However, there has yet to be a deal from a bank on the EU's southern fringe. The last was from a UniCredit subsidiary in June. That suggests the senior unsecured market remains tiered between so-called core and peripheral European banks.

But a larger threat may loom on the horizon for senior unsecured issuance. Banks face a redemption hump of some €300bn worth of government-guaranteed debt in the first quarter of 2012 which will need to be replaced. After that, banks may choose to start deleveraging their balance sheets in the face of higher capital requirements and funding costs, which may eat into profit margins on loans and assets.

"I think if you combine the shift to more capital with the bail-ins, there's no doubt that each of those steps individually makes banks safer," says one banker.

"But my fear is that there are two different medicines being prescribed. They will lead to higher costs, and the ultimate outcome will be deleveraging by banks."