

## Credit Quality Among European Corporates Is On A Positive Track For 2011, Less So For Banks

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# Credit Quality Among European Corporates Is On A Positive Track For 2011, Less So For Banks

The year 2011 could be one of diverging fortunes for credit quality in Europe, in our opinion. On the one hand, we expect that most corporate sectors will benefit from stabilizing and even improving business outlooks, while on the other, we believe governments, parts of the banking sector, and to a lesser degree insurance companies could see their credit quality come under pressure given the persisting overhang from the recent financial turmoil.

Looking further ahead, we believe that market sentiment could be clouded by the prospect of sizable funding requirements of close to €16 trillion between 2011 and 2015 across all sectors, resulting in continuing volatile risk premiums and fluctuating investor demand. Furthermore, we anticipate that ongoing structural changes in European debt capital markets will have a long-lasting impact on participants' behavior. These include the introduction of new prudential regulations known as Basel III for banks and Solvency II for insurance companies, as well as the emergence of a sizable European high-yield market, which in our view is part of a structural shift away from the traditional heavy reliance on bank financing.

Standard & Poor's Ratings Services believes that further improvements in corporate credit quality could result in corporate rating upgrades outnumbering downgrades in 2011, and the corporate speculative-grade default rate, which we derive from our private credit estimate database combined with publicly rated entities, edging down from 5.9% at the end of September 2010. This would likely take the trailing 12-month European default rate below its longer term 4.3% average for the first time since the onset of the financial turmoil in fourth-quarter 2008.

We envisage that as of December 2011 the corporate speculative-grade default rate could fall modestly to 3.8%. This would translate into 27 defaults in Western Europe (covering the EU-27 countries plus Norway, Switzerland, and Iceland) over the course of 2011.

Judging by the direction of our outlooks and CreditWatch placements in other sectors, however, we don't think these improvements are likely to be uniform. We believe that ratings on governments, banks, and to a lesser degree insurance companies could face downward pressures. For corporates, meanwhile, we believe 2011 may be relatively calm before a second wave of defaults returns in 2012. We believe that a combination of overleveraged balance sheets and higher spread margins against a rising interest-rate environment will likely result in more restructurings as shareholders' attention moves to creating value on new transactions. We could envisage the default rate returning to the 5.5%-7.5% range in 2012 based on our current assessment of the credit quality of these issuers and default probabilities returning toward their one-year historical average.

## Nervous Markets And Refinancing Risks Could Drag On Ratings...

Over the coming 12 months, we believe the following three broad themes will likely weigh on credit quality across Europe:

- Persisting adversity for banks in Europe, including high rates of nonperforming loans, a transition towards increased capital and liquidity requirements, and more expensive funding for many banks. This could limit their

lending capacity and in turn constrain investment.

- Continued anemic consumption in southern European countries as well as France, Ireland, and the U.K. This is because we envisage that unemployment will likely remain high and consumer confidence weak. Governments in these countries are unlikely to provide further fiscal stimulus that could help consumers, in our view, because they are already implementing severe fiscal retrenchments. Standard & Poor's forecasts real GDP growth of 1.8% in the Eurozone in 2011 and an unemployment rate of 9.8%, down modestly from its peak in 2010.
- Continued edginess by market participants about the capacity of several sovereigns to fix fiscal imbalances, and about the solvency of Irish banks and certain local and regional banks in Spain, where the savings bank sector is undergoing restructuring. This is despite the 2010 stress testing exercises carried out by EU banking regulators with the aim of improving transparency.

Furthermore, over the coming five years we believe that the confluence of sizable funding requirements by sovereigns, sub-sovereigns, financial institutions, noninvestment-grade corporates, commercial real estate borrowers, and leveraged buyouts (LBOs) could cause funding costs to rise if questions linger about the solvency of these issuers. However, we also expect that long-term interest rates will likely be on the rise in 2011 as bond market conditions become less issuer-friendly.

We expect that sovereigns will comprise the largest portion of this upcoming financing round, to the tune of €2 trillion per year until 2015 according to our calculation, and will not only include debt rollovers but also new debt to finance primary budget deficits.

We estimate that European banks will have to refinance more than €2 trillion of debt by 2015. Of this total, and according to our calculation, €1 trillion is government-guaranteed bank debt that needs to be replaced by 2012 and which represents a substantial 15%-20% of outstanding debt securities of European banks.

From a corporate perspective, we consider that the substantial number of weaker speculative-grade companies (mainly LBOs) that have €229 billion outstanding in leveraged loans maturing before December 2015 might face difficulties refinancing their debt on a timely basis. In our view, this is likely to become a more salient issue in 2012 rather than 2011.

Meanwhile, while maturity rollovers for commercial real estate appears more manageable at about €600 billion by the end of 2015, we believe that market disruptions could still arise upon refinancing if solvency issues exist for these highly leveraged transactions.

### **...But Optimism Is Resurfacing In Some Markets**

Although we don't underestimate these difficulties, we believe some strong countervailing forces exist that support further improvements in corporate credit quality. First, we envisage that export-oriented and commodity sectors such as capital goods, service companies, autos, chemicals, and mining could be buoyed by continuing robust Asian economies. We also expect other sectors, such as transportation, packaging, and building materials to gain from improved business conditions in 2011, albeit from depressed levels for some.

Second, we believe that consumption could rebound in Germany, Austria, Switzerland, The Netherlands, and the Scandinavian countries as unemployment gradually recedes from recession highs. This could rekindle consumer-related sectors in these countries.

Third, we anticipate that investors' risk appetite for speculative-grade issuers (that is, those rated 'BB+' and below) and vanilla securitizations will strengthen further over the next year. With low prevailing yields and an ongoing retrenchment by banks from lending to midsize firms, we see that institutional investors have poured into the high-yield market. As a result, 2010 is shaping up to have the highest volume of high-yield issuance in Europe on record, and we expect 2011 to be of the same vintage. We also believe that green shoots observed in 2010 in structured finance markets will likely firm up next year, with mainstream investors gradually returning to the more plain vanilla residential mortgage-backed securities and asset-backed securities, such as auto loans and credit card securitizations.

## **Regulatory Changes Augur Long-Lasting Changes In Markets Patterns**

Over the next few years, significant regulatory changes could, when implemented, have lasting effects on the behavior of market participants, in our view. The introduction of Solvency II in 2013 and new accounting standards may, depending on their final calibrations, require many insurers to raise capital and adversely impact their cost of capital. We believe their investment behavior may also change based on the introduction of regulatory risk capital requirements for different asset classes--currently there are no such requirements. We expect that banks will likely undergo systemic changes as they implement the new Basel III regulatory framework, although we understand that these are likely to be introduced gradually until 2018. In particular, banks will have tougher capital requirements, as will insurance companies under Solvency II, but will also have to get ready to meet leverage, liquidity, and funding tests. We further believe that systemically important financial institutions will be required to meet higher capital levels than will non-systemically important entities.

One of the results of the introduction of Basel III, combined with the ongoing credit issues that we consider are currently beleaguering various banks across the region, could in our view be a further disintermediation of the debt market. Over time, we believe that this could yield a well-established European high-yield market that could easily rival in size that of the U.S. given the fertile environment for midsize companies in Europe. Taking stock of 20 years of high-yield issuance in the U.S., we nevertheless acknowledge the fickle nature of this market, which can be very sensitive to negative sentiment. As a result, we believe that its development will not necessarily be linear.

Our outlook for 2011 is predicated on policies of the European Central Bank (ECB) and the Bank of England (BoE) remaining supportive. While the BoE's ongoing support seems likely in our view, we believe more uncertainties exist about the ECB's next steps. The strengthening of the German economy, the pick up--albeit modest--of eurozone headline inflation, and the possible replacement of ECB President Jean-Claude Trichet by someone from the ECB council dedicated primarily if not solely to controlling inflation could in our view lead the ECB to implement an exit strategy from its funding program as early as third-quarter 2011. In that case, bank funding by the ECB would likely become more constrained.

The political calendar will be busy in 2012 in France, Spain, Russia, and the U.S. With current governments standing for re-election over the next year, we believe that their focus will likely remain on the implementation of fiscal and budgetary consolidation, with the aim of entering the upcoming election year with concrete economic accomplishments.

We also anticipate that the EU will cement its institutional response to the stress experienced by Greece and Ireland. We view the creation in May of 2010 of the European Financial Stability Mechanism as a positive step to help the Eurozone's most vulnerable members implement much needed fiscal retrenchment. We believe, however, that

investors expect stronger signals about the permanence and behavior of these institutions.

## Corporate Defaults Deferred, Not Disappearing In 2011

In 2011, we anticipate that the rate of corporate defaults will continue the slowdown that started in late 2009. Yet, we think this will mark only a temporary respite. Tighter monetary policies and refinancing risks could in our view precipitate a resurgence of corporate defaults in 2012 and 2013.

So far in 2010, the pace of corporate defaults has declined sharply on 2009. The trailing 12-month speculative-grade default rate among industrial companies in Western Europe was 5.9% at the end of September 2010, down from the peak of 14.8% at the end of third-quarter 2009. This reflects a total 24 defaults in 2010 by Sept. 30 (comprising five rated entities, one of them confidential, and 19 credit estimates), affecting €17.0 billion of outstanding funded debt and compares with 103 defaulters for full-year 2009 on €62.4 billion of funded debt (see table 1).

**Table 1**

European Corporate Defaults Of Rated Companies 2010*						
Date	Parent company	Country	Sector/subsector	To	From	Reason
April 21, 2010	HIT Entertainment Ltd.	U.K.	Media and entertainment	SD	CC	Distressed exchange
June 2, 2010	Truvo Intermediate LLC	Belgium	Media and entertainment	SD	CC	Missed payment
June 28, 2010	Trico Supply AS	Norway	Energy	D	CC	Missed payment
July 5, 2010	WIND Hellas Telecommunications S.A.	Greece	Telecommunications	SD	CC	Missed payment

\*Data as of Dec. 2, 2010. Note: Europe covers EU-27 countries, plus Iceland, Norway, and Switzerland. Source: Standard & Poor's Global Fixed Income Research.

By year-end 2010, we anticipate that the combined default rate will have fallen further to about 4% (see chart 1). This would take the trailing 12-month European default rate below its longer term 4.3% average for the first time since the onset of the financial turmoil in fourth-quarter 2008.

A 4% default rate at year-end would also be materially below the base-case projection that we made a year ago of 8.7% for the end of 2010. We believe this reflects the following two factors that we have observed over the past 12 months:

- A stronger economic recovery in the major European economies in the course of this year than we earlier anticipated, particularly in Germany and the U.K., notwithstanding the fall in business confidence prior to the emergency rescue package put together to support Greece in April and May.
- Very low short-term interest rates that have benefited corporate cash flows and coverage ratios. We believe this has been a key factor in explaining the pragmatic behavior of both bank and institutional lenders, who have adopted an accrual-based policy of forbearance that has tended to favor amending covenants in return for fee payments and higher spread margins.

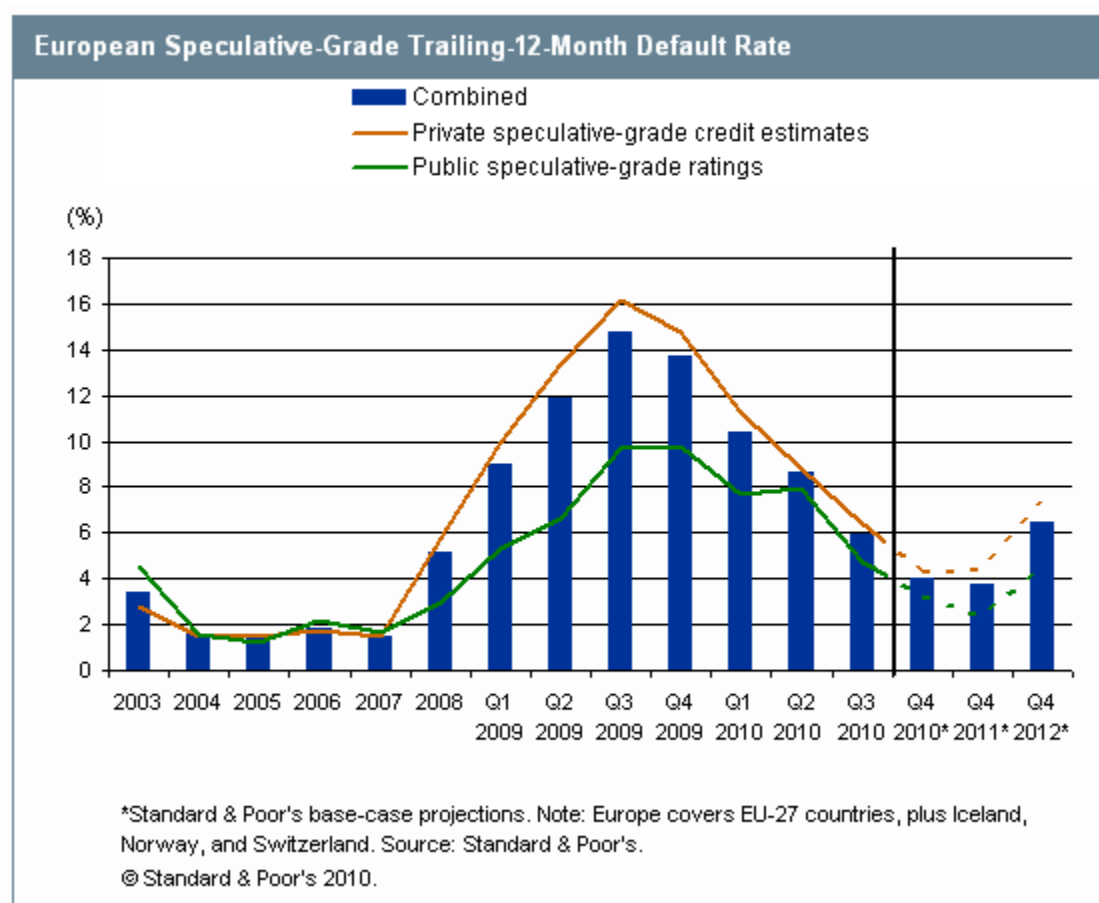
On our base-case assumptions that central bank policies will remain highly supportive in 2011, that the economic environment will stay relatively stable, and that the high-yield market will continue to enable many 'B+' and 'B' rated companies to refinance senior and mezzanine debt in good time, we envisage that the default rate will decline modestly to 3.8% as of December 2011. This would translate into 27 defaults over the course of the year.

In the context of this estimate for 2011 we believe that companies' present rating distribution should be noted, particularly in our credit-estimate portfolio, where the percentage of credit estimates at 'B-' and 'CCC' was 28.1%

and 17.6%, respectively, at the end of third-quarter 2010. This is sharply higher than the 24.7% and 7.3% of the credit estimate portfolio at these rating levels at the end of 2009. Nevertheless, we believe the presently high percentage of ratings at such a low level partly reflects the large number of recent defaulters that still reside in the 'B-' and 'CCC' categories post restructuring

However, looking further ahead to 2012/2013, we envisage an environment of tighter monetary policy and refinancing risk that will likely weigh more heavily on our assessment of credit quality. We therefore see a high likelihood of a second wave of defaults, mainly among leveraged buyouts (LBOs) vintage 2006-2008, on which we maintain private credit estimates. Given the high proportion of loans that we continue to view as vulnerable in the 'B-' and 'CCC' categories, which in many cases we think are due to excessive leverage, we believe it would require only fairly modest variations in our economic assumptions and lender behavior for the default rate to rise materially.

**Chart 1**



## Upgrades Are Starting To Outnumber Downgrades

The stronger rebound in European corporate operating performance in 2010, leading to strengthening earnings through the year, has also resulted in upgrades starting to outpace downgrades in the third quarter of 2010 (see chart 2). We expect this improvement in corporate credit quality to continue in 2011 as the recovery becomes more entrenched.

Nonetheless, we believe that this improvement has masked a growing divergence between companies operating internationally or in northern European countries and those companies that are most exposed to government austerity programs, such as in Greece and Ireland. We believe this divergence has started to weigh on the credit quality of businesses reliant on these domestic markets for a large proportion of their business. Nevertheless, apart from the utility sector and telecommunications incumbents, few of our rated companies fall into these categories.

As well as the rising pace of upgrades versus downgrades in the third quarter of 2010, the overall number of rating actions has started to slow, reflecting in our view a more stable operating environment. We also note that credit quality appears to be improving at a faster rate for speculative-grade companies than for higher rated firms. Upgrades among investment-grade companies have been running at a fairly constant 1.5%-2.0% per quarter over the past two years, while downgrades of investment-grade firms were significantly higher at 4.9% and 5.1% in the first and second quarters of 2010, respectively (see charts 3 and 4). Still, we note that the number of downgrades has fallen and is now more in line with the rate of upgrades in the third quarter. The downgrades were predominantly in the transportation, energy, and utilities sectors. We broadly attribute this to the impact of national austerity programs and sovereign downgrades, but also to other specific factors, such as the Gulf of Mexico oil spill.

**Chart 2**

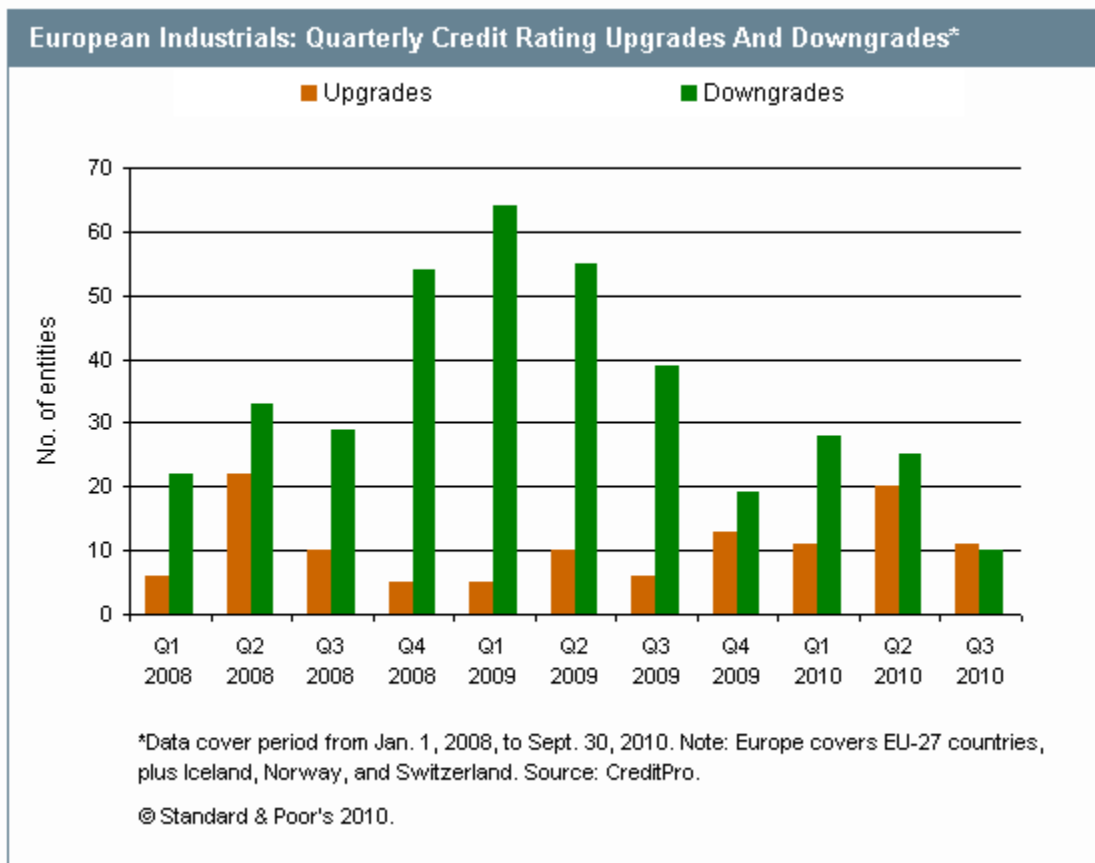


Chart 3

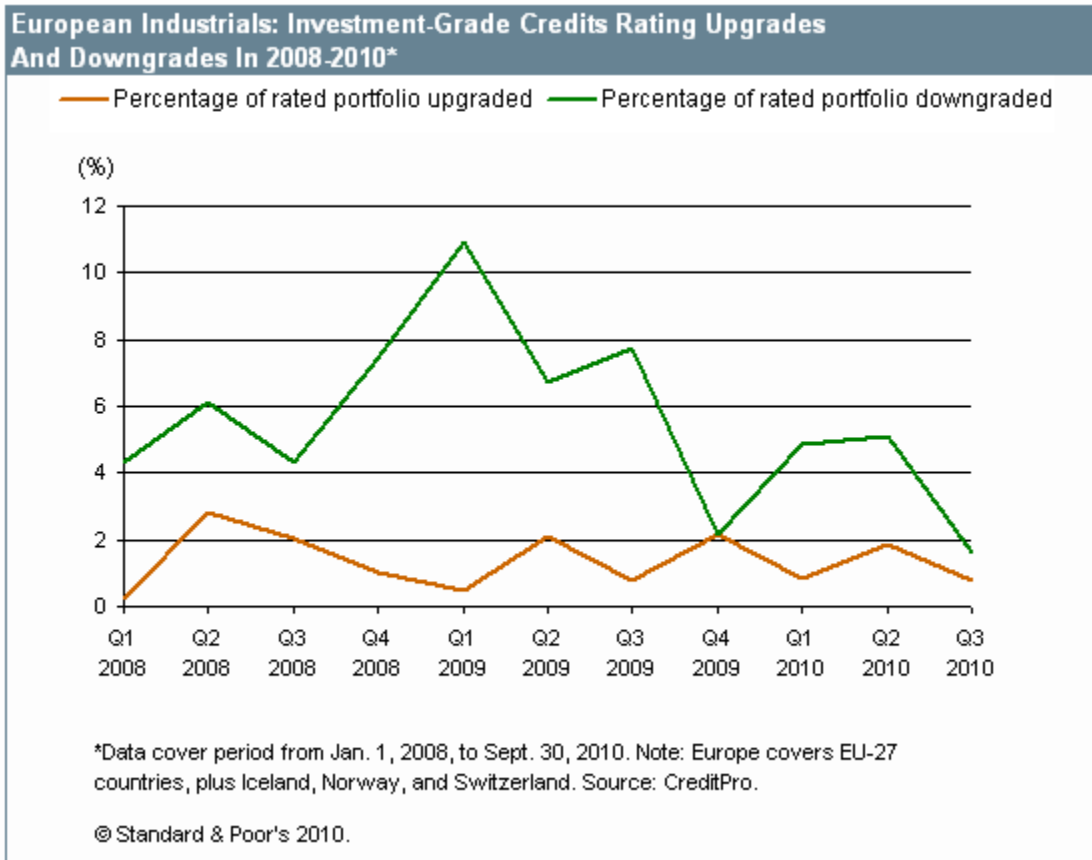
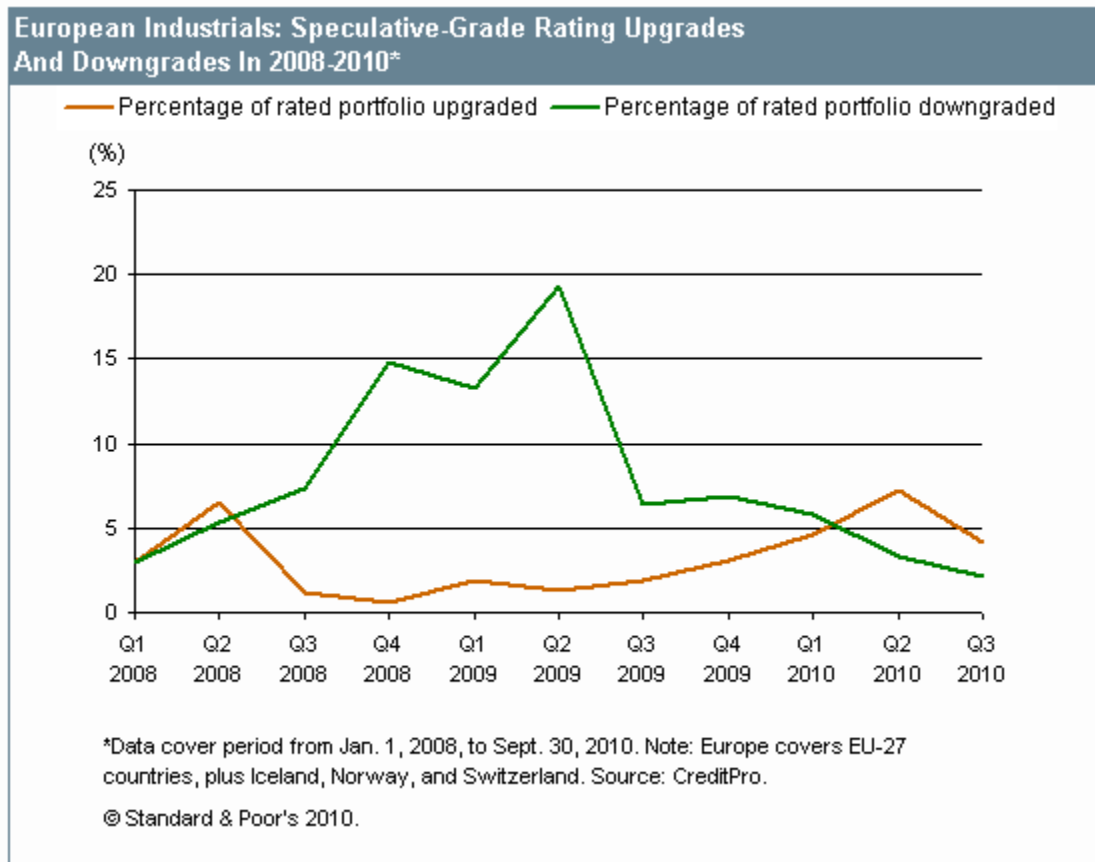


Chart 4



By contrast, we have seen that credit quality has been improving consistently through 2010 for many speculative-grade issuers. We believe this is because they have benefitted both from stronger operational performance and greater market access to liquidity, which has alleviated their near-term financial risks. We upgraded 7.2% of speculative-grade companies in the second quarter of 2010 and 4.2% in the third quarter--which was more than twice the percentage of downgrades. This trend has been most evident in the chemicals and high-technology sectors, where the net percentage of upgrades in 2010 was above 20% of rated issuers in these sectors.

There have been 10 entities downgraded to speculative grade from investment grade in 2010 through to mid November (see table 2). Six of these, however, were related to the sovereign downgrade on Greece. The U.K. conglomerate Tomkins Finance Ltd. was subject to a leveraged buyout from Onex Corporation and Canada Pension Plan Investment Board in July 2010, which resulted in a four-notch downgrade to 'BB-' for the acquisition vehicle Pinafore Holdings B.V.

Meanwhile, Netherlands-based specialty plastics producer SABIC Innovative Plastics Holding B.V. (BBB-/Stable/--) was one of only three companies whose ratings rose from speculative grade to investment grade in 2010, upgraded in July as a result of its strong operational performance and a capital injection from the company's parent (see table 4).

Table 2

Standard & Poor's European Downgrades Below Investment Grade (Fallen Angels) 2010*						
Date	Issuer	To	From	Sector	Country	Debt (mil. \$)
Nov. 26, 2010	Anglo Irish Bank Corp. Ltd.	B	BBB	Bank	Ireland	N/A
Nov. 18, 2010	UGF Banca SpA	BB+	BBB-	Bank	Italy	N/A
Oct. 7, 2010	Banca Carim - Cassa di Risparmio di Rimini SpA	BB	BBB-	Bank	Italy	70
Sept. 13, 2010	Tomkins Finance PLC (Pinafore Holdings B.V.)	BB-	BBB	Capital goods	U.K.	614
April 27, 2010	Piraeus Bank S.A.	BB	BBB	Bank	Greece	5,872
April 27, 2010	EFG Eurobank Ergasias S.A.¶	BB	BBB	Bank	Greece	14,177
April 27, 2010	National Bank of Greece S.A.	BB+	BBB+	Bank	Greece	1,323
April 27, 2010	Alpha Bank A.E.¶	BB	BBB	Bank	Greece	29,217
April 27, 2010	Hellenic Republic	BB+	BBB+	Sovereign	Greece	332,890
Feb. 19, 2010	Public Power Corp. S.A.	BB+	BBB-	Utility	Greece	544

\*Data as of Dec. 2, 2010. ¶Standard & Poors equity-based index constituent. Note: Debt amounts are usually just rated debt. Debt amounts for parent companies include subsidiary debt. Europe covers EU-27 countries, plus Iceland, Norway, and Switzerland. Source: Standard & Poor's Global Fixed Income Research.

Table 3

Standard & Poor's European Potential Downgrades Below Investment Grade (Fallen Angels)				
Issuers Rated 'BBB-' On CreditWatch With Negative Implications				
Subsector	Issuer	Country	Debt amount (mil. US\$)	Business risk
Media and entertainment	Accor S.A.	France	2,018	Satisfactory
Metals and mining	SSAB AB	Sweden	2,023	Satisfactory
Issuers Rated 'BBB-' With Negative Outlooks				
Bank	F&C Asset Management PLC	U.K.	443	
Financial institutions	Franz Haniel & Cie GmbH	Germany	2,088	Satisfactory
Building materials	Lafarge S.A.	France	14,464	Strong
Sovereign	Republic of Hungary	Hungary	55,606	
Sovereign	Republic of Iceland	Iceland	8,204	
Transportation	Autoroutes Paris-Rhin-Rhone S.A.	France	1,670	Excellent

Data as of Dec. 2, 2010. Europe--covers EU-27 countries, plus Iceland, Norway, and Switzerland. Note: Debt amounts are usually just rated debt. Debt amounts for parent companies include subsidiary debt. Source: Standard & Poor's Global Fixed Income Research.

Table 4

Standard & Poor's Stars European Entities Upgraded From Investment Grade From Speculative Grade (Rising Stars) 2010*						
Date	Issuer	To	From	Sector/subsector	Country	Debt affected (mil. US\$)
Oct. 1, 2010	Gecina	BBB-	BB+	Real estate	France	1,800
Sept. 6, 2010	SABIC Innovative Plastics Holding B.V.	BBB-	BB	Chemicals	Netherlands	8,165

\*Data as of Dec.2, 2010. Note: Europe covers EU-27 countries, plus Iceland, Norway, and Switzerland. Source: Standard & Poor's Global Fixed Income Research.

Table 5

European Corporations Rated By Standard & Poor's 'B-' Or Lower With Either Negative Outlook CreditWatch Negative 2010*			
Entities Rated 'B-' Or Lower With Either A Negative Outlook Or Ratings On CreditWatch Negative			
Rating combination and subsector	Issuer	Debt (mil. US\$)	Country
<b>B-/Outlook Negative</b>			
Chemicals, packaging, and environmental services	Kleopatra Lux 1 S.a.r.l	0	Luxembourg
Forest products and building materials	Norske Skogindustrier ASA	1,807	Norway
Media and entertainment	TUI AG	3,910	Germany
Oil and gas exploration and production	Expro Holdings U.K. 3 Ltd.	3,627	U.K.
Transportation	SAS AB	0	Sweden
<b>CCC+/Outlook Negative</b>			
Aerospace and defense	Heckler & Koch GmbH	165	Germany
Chemicals, packaging, and environmental services	Yioula Glassworks S.A.	183	Greece
Telecommunications	ERC Ireland Preferred Equity Ltd.	5,892	Ireland
<b>CCC/CreditWatch Neg</b>			
Chemicals, packaging, and environmental services	Schoeller Arca Systems Holding B.V.	507	Netherlands
<b>CCC-/Outlook Negative</b>			
Oil and gas exploration and production	Turbo Alpha Ltd. (Turbo Beta PLC)	1,400	U.K.
Metals, mining, and steel	Zlomrex S.A.	175	Poland

\*Data as of Dec. 2, 2010. Note: Debt amounts are usually just rated debt. Debt amounts for parent companies include subsidiary debt. Europe covers EU-27 countries, plus Iceland, Norway, and Switzerland. Source: Standard & Poor's Global Fixed Income Research.

## Corporate Credit Quality Should Climb In 2011 On A Sustained Recovery

Amid the tentative recovery which we believe exists in European corporate credit quality we note that companies in most sectors appear to be starting to become more confident that a sustained recovery, albeit still somewhat anemic by historical standards, is in sight for 2011. Already in 2010, earnings and cash flow performance has turned out to have been much better than we and most of the companies concerned, had expected a year ago, even in some of the most cyclical sectors such as autos and chemicals. In our view, many company management teams have contributed significantly to this upturn in performance in several ways. First, many have introduced quite aggressive cost-saving programs in response to the severity of the downturn in late 2008, which has improved operational leverage. Second, many companies have been careful to maintain pricing discipline despite rising input prices and surplus capacity. Third, in response to the dislocation in the banking industry, many companies have focused stringently on preserving liquidity by restricting capital expenditure programs, tightening working capital, and limiting shareholder payouts and other more expansionary activities.

This has led to a sharp recovery in EBITDA and funds from operations among larger companies, in our observation, which are not far off figures achieved at the top of the cycle in the first half of 2008. While we don't expect earnings growth to continue at the same pace in 2011, and we believe there will be some significant variation in performance across sectors and countries, in general we anticipate the following common themes will likely impact different sectors to varying degrees in 2011:

- A rise in cost and margin pressures. We anticipate that the pace of growth will slow in certain industries in 2011, particularly in the steel, chemicals, capital goods, and auto industries. Combined with continued cost pressures--particularly from raw materials and energy, and greater competition in pricing, particularly for telecoms and building materials firms--we consider it likely that pricing power and operating margins could come under some pressure.
- A return to capital investments. After a lackluster two years, we consider heavier capital spending is particularly likely in the retail, leisure, and auto sectors. We note that this is already being reflected in early- to mid-cycle capital goods producers' order books and we anticipate a pick-up in the late-cycle segment in late 2011 or early 2012.
- An increase in dividend payouts and share buybacks. As cash flow improves and capital markets recover, we see signs that managements may adopt a less defensive financial policy, particularly pharmaceuticals and capital goods firms. We also anticipate the return of some LBO recapitalizations among higher rated companies.
- More mergers and acquisitions. In our view, companies in certain sectors, such as packaging or chemicals, may now have some headroom within their existing ratings to accommodate small or midsize acquisitions. We believe there could be larger acquisitions in 2011 in industries such as airlines, media, and mining, which are consolidating, or where companies see strategic growth opportunities to deploy excess cash and capitalize on cheap funding in the debt capital markets. We recognize, however, that a necessary condition for this is the availability of bank financing in the form of undrawn facilities to support any acquisitions, even where a quick capital-markets takeout is planned.
- And expansion of production capacity. In response to strong demand, primarily from the developing world, we anticipate that certain sectors are likely to expand production capacity, particularly in mining and semiconductors. This would likely increase the potential risk of future supply-demand imbalances in these highly cyclical industries in the medium term, in our view.

## Prospects Are Improving In Most Sectors—With A Few Notable Exceptions

While our outlooks on the majority of corporate sectors still retain a negative bias, our expectation of a stable or slightly positive rating trend across most of these sectors in 2011 suggests some potential for further improvement in the balance of outlooks as well as in the number of upgrades through 2011. (see chart 5 and table 6).

Nevertheless, we consider that three sectors have weaker prospects for industry-specific reasons:

- The European utilities sector appears to us to be exposed to specific difficulties, which we believe will continue to exert downward pressure on ratings over the medium term. These include balance sheets overburdened with debt incurred to finance acquisitions in 2006-2008; a need to modernize electricity production and invest in renewable energy; a decoupling of oil and gas prices; and growing concerns that deteriorating sovereign risk may affect regulation, tariff, or tax policies imposed on utilities (for further details see "Top European Utilities Could Lose Their Spark Amid Increased Risk," published Nov. 19, 2010, on RatingsDirect).
- The steel sector remains weak, in our view, due to a combination of a capacity oversupply at the same time as input costs--mainly iron ore and energy prices--have squeezed operating margins and profitability. The recent adoption of contracting for iron ore on the basis of average quarterly pricing reflects the relative bargaining power of the miners versus the steel producers and their desire to capitalize on more volatile prices, in our opinion.
- The downstream oil and gas industry globally continues to suffer from structural overcapacity, in our

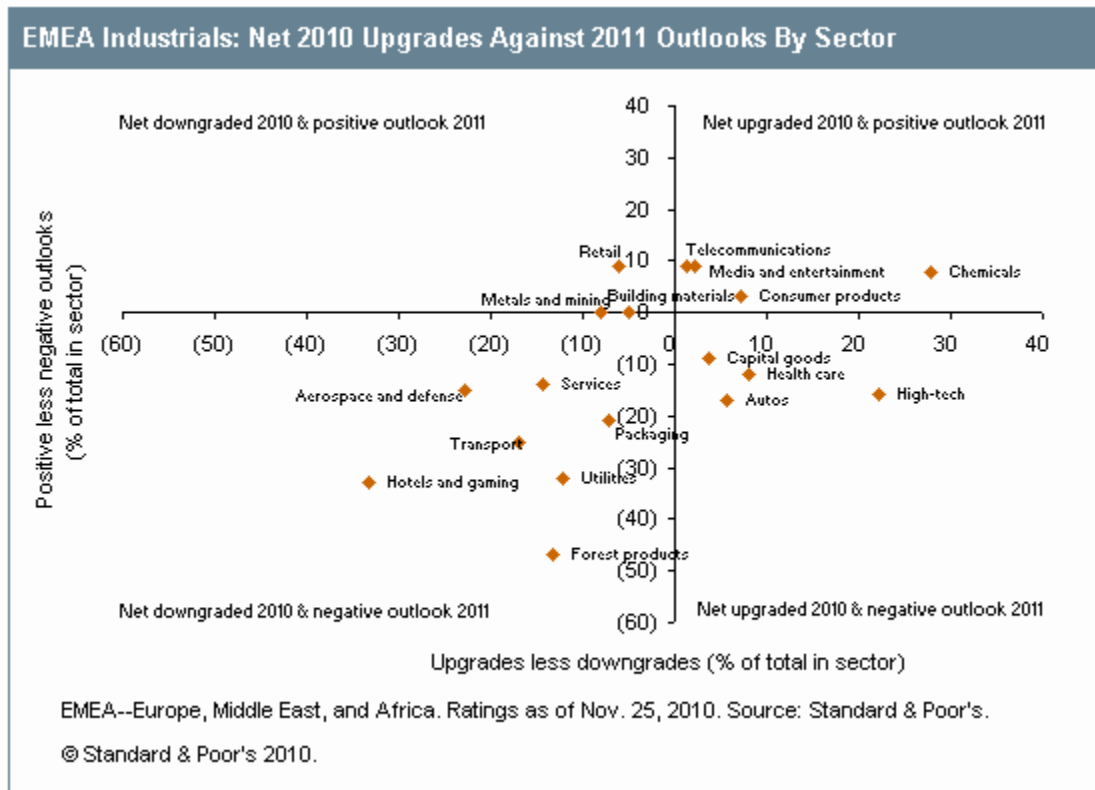
observation. While we expect the European refining sector to continue to benefit from a modest recovery in demand, capacity utilization is still low and underperforming European refineries still face closure or restructuring. Increasing working capital and the associated increase in debt could further pressure credit metrics and free cash flow, in our view.

**Table 6**

<b>European Industrials: Business And Financial Conditions And Rating Trends By Sector 2010-2011*</b>					
	<b>--Business conditions--</b>		<b>Relative business trends</b>	<b>Free cash flow generation</b>	<b>Projected rating trend</b>
	<b>2010</b>	<b>2011</b>	<b>--2011 compared with 2010--</b>		
Autocomponents	Strong	Strong	Weakening somewhat	Deteriorating modestly	Positive to Stable
Automakers	Strong	Strong	Weakening somewhat	Deteriorating modestly	Positive to Stable
Capital goods	Satisfactory	Strong	Improving somewhat	Deteriorating modestly	Positive to Stable
Chemicals	Very strong	Strong	Weakening somewhat	Stable	Positive to Stable
Mining	Strong	Strong	No change	Moderately improving	Positive to Stable
Oil and gas (upstream)	Strong	Strong	No change	Moderately improving	Stable
Service companies	Satisfactory	Strong	Improving somewhat	Moderately improving	Positive to Stable
Trucks	Satisfactory	Strong	Improving somewhat	Deteriorating modestly	Positive to Stable
Aerospace and defense	Satisfactory	Satisfactory	Improving somewhat	Moderately improving	Stable
Consumer products	Satisfactory	Satisfactory	No change	Stable	Stable
Forest products	Satisfactory	Satisfactory	Improving somewhat	Stable	Positive to Stable
Leisure	Satisfactory	Satisfactory	No change	Stable	Stable
Media	Satisfactory	Satisfactory	No change	Moderately improving	Stable
Packaging	Satisfactory	Satisfactory	Improving somewhat	Moderately improving	Stable
Pharma and health care	Strong	Satisfactory	Weakening somewhat	Stable	Stable
Retail	Satisfactory	Satisfactory	No change	Deteriorating modestly	Negative to Stable
Technology	Strong	Satisfactory	No change	Moderately improving	Stable
Telecommunications (investment-grade)	Satisfactory	Satisfactory	No change	Stable	Stable
Telecommunications (speculative-grade)	Satisfactory	Satisfactory	No change	Stable	Positive to Stable
Transportation	Weak	Satisfactory	Improving somewhat	Moderately improving	Positive to Stable
Building materials	Very weak	Weak	Improving somewhat	Deteriorating modestly	Stable
Oil and gas (downstream)	Weak	Weak	No change	Moderately improving	Negative to Stable
Steel	Weak	Weak	No change	Stable	Stable
Utilities	Weak	Weak	Weakening somewhat	Stable	Negative

\*Data for 2011 are Standard & Poor's forecasts. Note: Europe covers EU-27 countries, plus Iceland, Norway, and Switzerland. Source: Standard & Poor's.

Chart 5



## Refinancing Risks Could Bring A Resurgence Of Defaults In 2012-2013

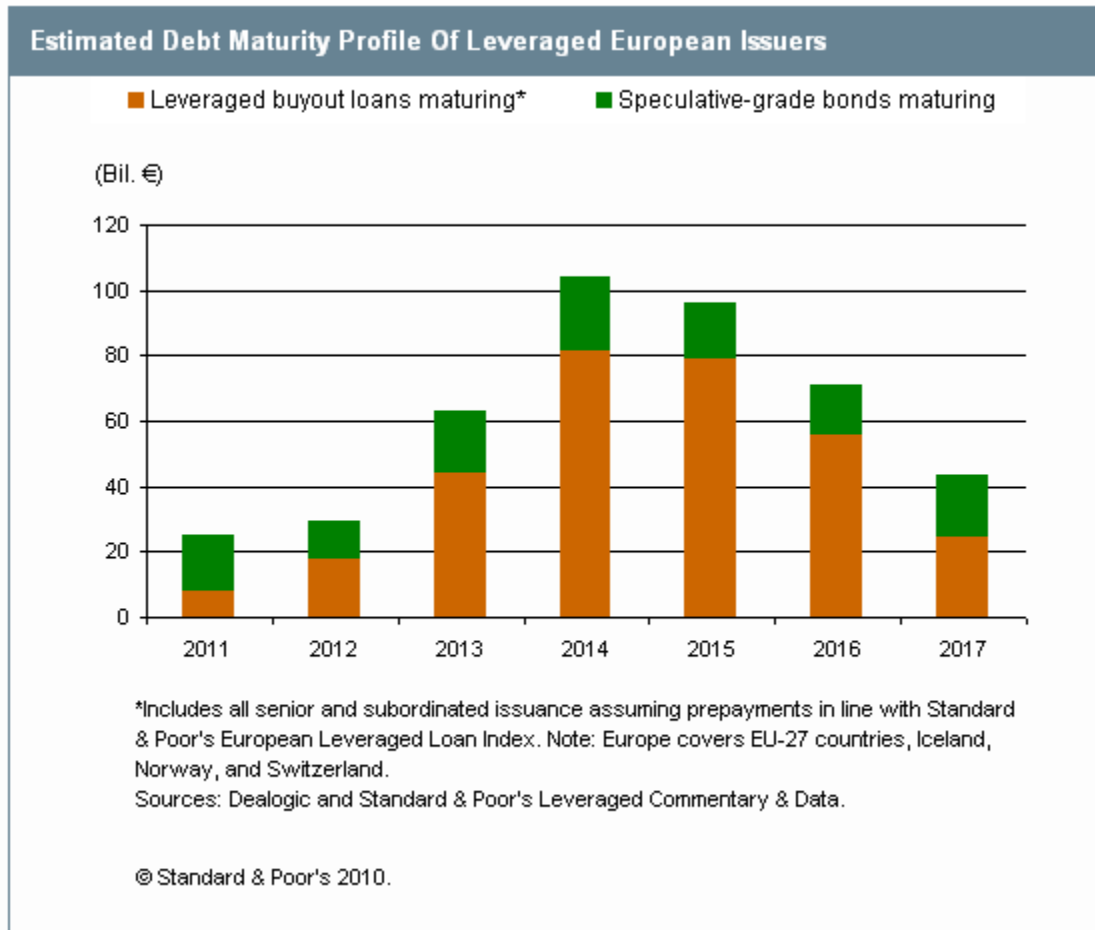
Looking beyond 2011, we believe refinancing risk for highly indebted European corporates could potentially generate a second wave of defaults in 2012 and 2013. We see two main reasons for this: a potential lack of sufficient funding available to enable debt to be rolled over on a timely basis; and the weak credit characteristics of a significant number of LBOs that we monitor (see chart 6).

Taking 2010 as a benchmark for the amount of debt-financing available, Standard & Poor's Leveraged Commentary and Data indicates that the leveraged loan market up until Nov. 18 this year provided €37.1 billion of rollover and new-loan financing, while the European high-yield market provided €42.4 billion, albeit in what will likely prove to be a record-breaking year. In this context, €26.3 billion in debt maturities in 2011 and €30.6 billion in 2012 does not seem too onerous in our view considering that the bulk of 2006/2007 vintage European collateralized loan obligation fund reinvestment periods do not begin to expire before 2013.

However, from our standpoint we see two significant factors that affect the likely timing and success of future refinancing for these credits. First, we believe the most important consideration is not the actual maturity date of the debt but rather the adverse credit implications for liquidity and financial flexibility if these typically highly leveraged credits do not start to address their refinancing requirements well in advance, that is, between 18 months and two years ahead of time (for further details see "Methodology And Assumptions: Standard & Poor's Standardizes Liquidity Descriptors For Global Corporate Issuers," published July 2, 2010).

Furthermore, we track a substantial number of LBOs, mainly in our private credit estimate portfolio, that are smaller companies, the operational performance of which has been adversely affected by the economic downturn. We have doubts that many of the more highly leveraged companies that we perceive as vulnerable and have assigned to the 'CCC' category (representing 14.7% of our overall portfolio at the end of the third quarter of 2008) will be able to avoid a financial restructuring in 2012/2013. This is likely in our view to include many of the 102 LBOs that have already defaulted since 2008 that remain in our private credit estimate portfolio, of which 60% are in the 'CCC' or 'CC' categories.

**Chart 6**



## A Two-Tier Banking Industry Is Emerging

We see continuing signs of a two-tier European banking industry emerging, making it difficult to assess the state of the industry as a whole, in our view. Although the position of various European banks appears to be stabilizing, we believe many face increasing strategic and commercial challenges. This is reflected in the high (one-third) proportion of negative outlooks and CreditWatch negative placements that we still have on banks in the sector.

We believe that the following five themes will dominate bank ratings in 2011:

## **1. The funding challenge**

Access to wholesale market funding has reopened for those European banks that benefit from market confidence, but funding still constitutes a pressure point for the region's banking system overall, in our view. Wholesale market sentiment continues to be fragile, and some sectors (such as Irish, Greek, and Portuguese banks) are reliant on central banks for continued access to funding. We expect funding strategies to be important factors influencing creditworthiness as certain European banks move away from central bank funding and look to rebalance their funding sources. We also think this is likely to squeeze margins for many banks.

We anticipate heightened competition to access funding as European banks look to refinance more than €2 trillion of debt by 2015. Of this total, we calculate that €1 trillion is government-guaranteed bank debt that needs to be replaced by 2012, representing a substantial 15%-20% of the outstanding debt securities of European banks.

Despite what we believe is a greater industry awareness of funding risks, many banks have increased their reliance on short-term funding over the past three years. This appears partly to be because short-term funding was the most readily available wholesale source of funding during this period, and partly because central bank funding tends to be short-term in nature (albeit more likely to be rolled over than market funding). In our opinion, a return to a more balanced funding structure would likely promote increased stability in the banking industry. However, we believe this will take time and also put pressure on earnings, possibly discouraging some banks from moving quickly. We believe banks who do not start positioning themselves for the new funding requirements that will be phased in under the Basel III regulatory framework, may find it challenging to comply in a timely manner.

We anticipate that the two-tier funding market is likely to become more pronounced in 2011 as weaker banks find it more expensive to re-enter the wholesale funding market or try to extend their funding maturities. The large volume of refinancings due to come on the market may also crowd out weaker banks--to the benefit of stronger, more stable institutions. We believe that those banks that already have stronger funding positions will make better progress toward rebalancing and improving their funding bases in 2011, thereby widening the gap with weaker banks.

## **2. Interaction between European banks and European sovereigns**

In our view, the degree of support provided to national banking systems has weakened the creditworthiness of sovereigns such as the Republic of Ireland, while other European sovereigns such as Greece have experienced rating downgrades due to other structural issues. Deteriorating sovereign ratings typically also lead to lower bank ratings in the countries where the sovereign ratings have declined. Factors that we anticipate will come into play include bank exposure to national government debt (which will likely have fallen in value in the event of weaker sovereign credit quality the potential for reduced market access if foreign investors reduce their appetite for exposure to a particular country, and the implications of fiscal tightening on bank earnings.

## **3. The recovery in asset quality is not widespread**

We see signs of stabilizing or improving asset quality in some banking systems, such as those of Sweden, Germany, and France. Yet, the picture differs dramatically by geography and by lending sector. Overall, we believe that asset quality is still a constraint for European banks, and will continue to restrain industry earnings. The asset quality outlook differs greatly by country, given the diverging economic prospects of some markets, and also depends on how thorough the recognition of legacy problems has been. We consider that there has been broad restructuring of loans in some markets, potentially flattering the existing nonperforming loan (NPL) data. This holds risks for the future, in our view, depending on the pace at which (or whether) borrowers recover their strength, or at which collateral values improve.

We believe that continuing strains from asset quality will reinforce the diverging trend in the European banking sector. Those banks that are most constrained by poor asset quality tend to have less capacity to expand their business and thereby rebuild earnings and capital, than do those banks with healthier loan books in our view. We anticipate that the longer term strategic question of how to deal with restructured loan books is also likely to test the economics of some business lines.

#### **4. The transition toward higher capital requirements**

We see the race for capital as another key theme in 2011. Although banks have several years to prepare for the higher capital requirements outlined under Basel III, some national regulators (such as the Swiss) are already pressing their banks to move rapidly. Other banks (such as Standard Chartered Bank and Deutsche Bank AG; both rated A+/Stable/A-1) have decided to raise common equity promptly to take advantage of their comparative attractiveness to equity investors, with the aim of not getting crowded out if market capacity becomes exhausted.

The transition period for Basel III (including the grandfathering period for certain hybrid capital instruments may, in our view, lead some banks to believe that they do not need to address this adjustment for the moment. We anticipate that market expectations of what constitutes appropriate capitalization are likely to move quickly toward the new Basel III regulatory minima, and that banks that move slowly may find less investor capacity if they subsequently need to raise common equity. We believe there is a risk that lower-capitalized banks will find it hard to compete for capital against those with higher capital adequacy, which may also widen the gap in credit quality between such entities.

#### **5. The scope of government support**

The cost of recent bank bailouts has focused political attention on ways of reducing the taxpayer cost of future bank rescues, which we believe will be another major theme for 2011 and beyond. We increasingly see European governments willing to share the burden of a bank rescue with hybrid investors. The concept of burden-sharing for subordinated debt investors has also been used in some cases in the U.K. and Ireland.

In Europe, there is considerable debate about the scope and format of potential resolution regimes for dealing with failing banks, and their effect on bank bondholders. In addition to the policy considerations, in our view there are considerable logistical issues to address including legal frameworks, the potential for closer international cooperation, and the effect of banks' organizational structures. The end result is uncertain, but we believe that the likelihood of future government support toward subordinated bank investors is very low in the event of a bank rescue. We also believe that the uncertainty about the potential role of senior bank debt in a "bail in" situation (that is where senior bond holders would be required to take haircuts on their debt in the event that a failing bank receives government support) is likely to have an adverse effect on funding costs for weaker banks.

## **Despite Strong Balance Sheets, Insurers Are Uneasy About The Future**

The European insurance industry enters 2011 in a nervous state, in our view. While we believe that insurer balance sheets are mostly restored from their low point in the first quarter of 2009, the negative implications for the industry of regional and global economic trends are likely to be compounded in our opinion by the potential impact of Solvency II supervision and the International Accounting Standards Board's (IASB's) Phase 2 insurance accounting project. The bias in our rating profile is consequently negative, with 25% of our current ratings carrying negative outlooks or CreditWatch negative placements versus 5% positive, with the remaining 70% stable. Nevertheless, our view of the sector remains strong relative to other corporates, with an average long-term issuer credit rating of 'A-'.

The insurance industry seems to have had some success in getting its message across to global policymakers that it does not amplify risk in the financial system in the same way that banks do. As a result, we think insurers can avoid the systemic risk-related higher capital requirements that are being contemplated for major banks. In our opinion, insurers may reasonably claim that the industry dampens systemic risk in the global economy through its general ability and willingness to hold securities to maturity.

Insurers have suffered from the consequences of the financial turmoil that started in 2007. We have seen that the mark-to-market and impairment effects on their investments depleted their balance sheets substantially. Having reached a trough in the first quarter of 2009, we believe that capital adequacy has been restored by most of Europe's major insurers through a combination of good earnings and the reversal of adverse corporate credit spread movements. We attribute the reason for the latter point to insurers generally not being forced sellers of the instruments that were most affected during the turmoil.

In our view, insurers are more concerned now by the economic consequences that the financial turmoil has left behind. Low interest rates are an issue for many life insurers, especially for their liabilities on with-profit products that provide minimum guaranteed investment returns. While the resulting reinvestment risk is likely to be problematic for such insurers, we believe its impact will mostly be felt in the form of lower profitability. We anticipate that ratings on affected insurers will likely remain under pressure and this pressure will accumulate if the low interest rate environment is prolonged. A potential medium-term scenario of rising inflation and higher interest rates would relieve this pressure. However, we anticipate that it would also be likely to have an adverse effect on mark-to-market balance sheets and would erode expense margins.

We believe the economic consequences are also limiting life insurers' new business prospects. We attribute this to lower investor confidence (affecting savings and investment products), lower housing market activity (affecting mortgage-related products) and lower disposable incomes. Furthermore, the lapse rates of life insurance policies are somewhat elevated as policyholders surrender their policies or discontinue premium payments in order to realize or conserve cash. In addition, we have observed that in periods of low investment returns, insurers' costs typically substantially reduce the yield passed on to policyholders on savings products, thereby generally reducing their appeal relative to noninsurance savings products. In our view, these top-line issues have a direct bearing on insurers' profitability, as do the weaker returns on investments backing nonlinked policies and the charges that insurers levy on unit-linked policies and asset management products (which are largely based on the market value of the managed investments). On the non-life side, as is typical of recessionary conditions, claim frequency has increased in 2010.

We have noted that non-life insurers generally look nervously at inflation risk, especially those with significant long tail exposures, where inflation risk may not be adequately provided for in pricing. Generally, we note that pricing in most lines of business remains on a softening to flat path in most European markets, with the exception of U.K. and Italian motor insurance business. The price corrections seen in these latter markets were long overdue in our view, evidenced by very poor recent accident year performance. Looking ahead, we think that there will be an adverse affect on future non-life operating performance if economic activity does not continue on its modest upward path. This is also true of investment earnings, which appear to be making a much smaller contribution to insurers' overall performance at present than they did in the first half of the decade.

Non-life catastrophe activity (natural and man-made) was very high in the first half of the year but has been offset by a very benign North Atlantic hurricane season in the second half. Many reinsurers that were facing the prospect of underwriting losses for 2010 had the hurricane season been 'normal' should now report good levels of

profitability, in our view, although well below the record levels that some companies achieved in 2009.

## **Sovereign Risk Is Limited For Insurers**

In our opinion, sovereign risk is more likely to erode profits than present a capital threat to the European insurance industry. The recent lowering of the rating on the Republic of Ireland and consequent downgrades of Irish banks also resulted in CreditWatch actions on five Irish insurers, mostly small subsidiaries of large groups. These insurers are affected in our view through their holdings of government debt, deposits with Irish banks, and the prospects for the Irish economy. We have taken no rating actions on insurers as a direct consequence of Greek sovereign risk.

We continue to monitor insurers' exposure to Portugal, Spain, and Italy. We are also monitoring exposures to financial institutions' hybrid securities and, for those insurers with large U.S. subsidiaries, commercial mortgage-backed securities, collateralized debt obligations, commercial mortgages, commercial real estate, and residential mortgage-backed securities, that is, subprime and Alt-A.

## **Solvency II Supervision And New IASB Accounting Standard Put Cost Of Capital Under Pressure**

We have also noted that the implementation of Solvency II supervision, which goes live on Jan. 1, 2013, is also making insurers feel concerned. Although the advice on solvency capital requirements provided by the Committee of European Insurers and Occupational Pensions Supervisors was moderated by the European Commission (EC) in the final calibration of the fifth Quantitative Impact Study (QIS 5), it was significantly higher than the QIS 4 calibration. We consider Europe's larger insurers are likely to be less affected because of the relatively high capital credit they will likely receive for diversification under Solvency II and because of their likely use of internal models for solvency purposes. Even so, we believe that supervisory capital will become a binding constraint for many insurers. Capital-raising cannot be ruled out in our view, although the European Commission is likely to implement a package of transitional measures (involving the treatment of hybrid securities and non-EU supervisory equivalence, for instance) that we expect will limit the initial impact. As a consequence, we think Solvency II may adversely affect European insurers' cost of capital.

Cost of capital may also be adversely affected in our view by greater future reported profit volatility arising from the IASB's phase 2 insurance accounting standard. The IASB is nearing completion of the standard (the consultation period of its exposure draft has just closed), which is due to be published by June 2011, although implementation is unlikely before 2014.

**Table 7**

<b>Main European Economic Indicators</b>							
	<b>Germany</b>	<b>France</b>	<b>Italy</b>	<b>Spain</b>	<b>U.K.</b>	<b>Ireland</b>	<b>Eurozone</b>
<b>Real GDP (% change)</b>							
2008	1.3	0.4	(1.0)	0.9	(0.1)	(3.0)	0.4
2009	(5.0)	(2.5)	(5.0)	(3.6)	(5.0)	(7.6)	(4.0)
2010*	2.8	1.6	0.7	(0.5)	1.6	(0.8)	1.8
2011*	2.3	1.6	1.0	0.3	2.3	1.5	1.7

**Table 7**

**Main European Economic Indicators (cont.)**

<b>CPI inflation (%)</b>							
2008	2.8	3.2	3.5	4.1	3.6	4.1	3.3
2009	0.3	0.1	0.8	(0.3)	2.2	(4.5)	0.3
2010*	1.3	1.5	1.3	1.5	3.5	(1.2)	1.5
2011*	1.5	1.5	1.8	1.1	3.3	0.8	1.6
<b>Unemployment rate (%)</b>							
2008	7.3	7.8	6.8	11.3	5.6	6.0	7.5
2009	7.5	9.1	7.8	18.0	7.6	11.8	9.4
2010*	7.0	9.8	8.5	21.0	7.6	13.5	10.1
2011*	6.7	9.5	9.0	21.0	7.5	12.0	9.8

\*Standard & Poor's forecast. CPI--Consumer price index. Source: Standard & Poor's.

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