

The Revolver

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Source: RBS Credit Strategy

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ABS: A Better Solution for Europe

Europe is on the edge of deflation, while credit markets remain fragmented. *"The ECB must do something"* – say economists glued to their screens to forecast the size and shape of upcoming actions. But Europe's credit markets are complex, and those hoping for a Fed-style QE "bazooka" could end up disappointed. The solution in our view is reviving lending to the real economy – SMEs – through a new type of Asset Backed Securities. There are obstacles: the market is segmented and demand weak. A plan will have to start small and take time, and will require both monetary and fiscal support.

The ECB has two non-exclusive policy responses for weak inflation and credit:

- 1. Quantitative Easing (QE) to push up inflation.** Sovereign asset purchases could expand the ECB's balance sheet and lower the Euro, pushing up exports and inflation.
- 2. Credit Easing (CE) to boost lending and enhance the transmission of policy.** The TLTROs can help by lowering bank funding costs, but many banks still lack capital. Securitisations would allow bank lending, but without absorbing as much capital and without further expanding bank balance sheets, which in the Eurozone are still the largest in the world, at €30.9tn, over 3x the GDP.

A simple ABS structure could fit bank regulation better than covered bonds. ABS could help Europe to gradually move to a leaner banking system, improving capital, leverage and asset encumbrance ratios. They could also limit risk for unsecured bondholders in a bail-in, by reducing asset encumbrance.

There are significant challenges to an ABS recovery plan. High capital charges and strict regulation are the biggest obstacles for both issuers and investors. Other barriers to entry for new non-bank lenders are information asymmetries: lack of extensive public loan-level data and un-harmonised disclosures. Variations in legal systems and bankruptcy laws across Europe also make a level playing field more difficult.

ABS programme: no quick bazooka, but a structural solution. We think the ECB could buy ABS backed by SME, consumer and auto loans/leases, of which there is €300bn outstanding. The programme could start small (<€100bn) with purchases over many quarters/years, of both existing and new issues. To achieve a substantial impact on risk transfer, the ECB could buy not only senior tranches but may need to buy mezzanines as well, potentially with the help of national guarantees or the EIB.

Despite expectations of an imminent announcement, preparations could take several months given technical complexity. We think a programme could be announced from December, with implementation next year.

The ECB can't do it alone: more EU/EIB fiscal support, non-bank lending, bond markets are needed. Support from development banks and the EIB will be critical for the ECB to revive the credit-risky parts of the market. Besides ABS, other instruments can help to plug the €573bn gap in corporate loans left by bank deleveraging since the crisis. Other alternatives to bank lending are high yield bonds, mini-bonds as well as lending from non-bank institutions in the private and public sector.

Important disclosures can be found on the last page of this publication.

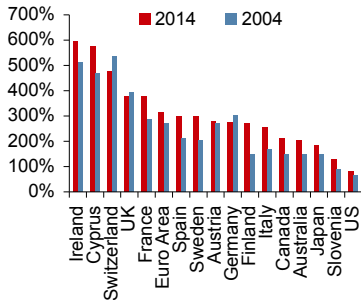
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1. A new way to fund the European economy

Banks are too large at 3x GDP

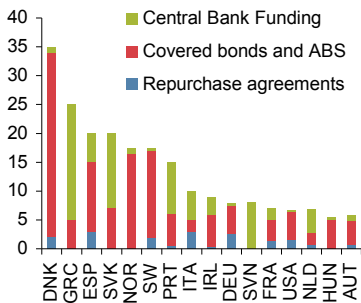
Bank assets, % GDP



Source: RBS Credit Strategy, ECB, IMF

Asset encumbrance: high

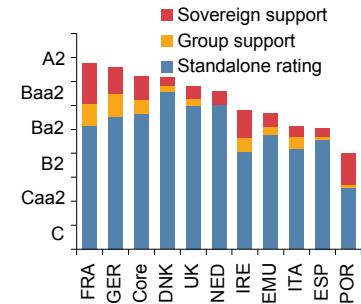
Funding that encumbers assets



Source: RBS Credit Strategy, IMF

Banks: implicit sovereign support

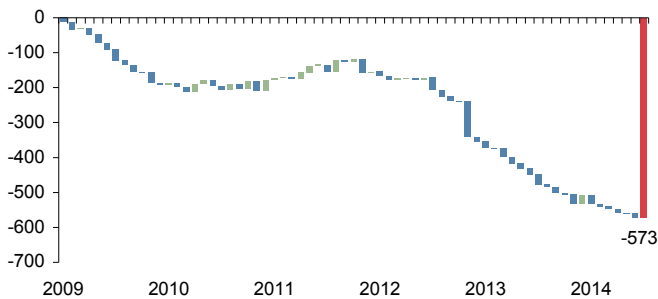
Sovereign support bank rating uplift



Source: RBS Credit Strategy, Moody's

Banks reduced lending to firms by €573bn after the crisis

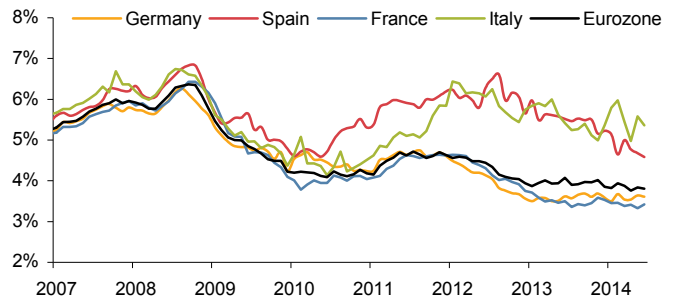
Decline in loans to non-financial corporations, €bn



Source: RBS Credit Strategy, ECB

SMEs find it harder and more expensive to borrow vs pre-crisis

Interest rate on 1-5y loan under €1mn, %



Source: RBS Credit Strategy, ECB

“SMEs are particularly vulnerable to banking sector stress, and as they employ nearly 70% of EU workers and contribute around 60% of EU value added, this creates a concomitant vulnerability for the European economy. Securitisation may be one way to stimulate credit to SMEs, as banks would feel more confident that they could shift risks to non-bank investors.”

– Vítor Constâncio, Vice-President of the ECB, December 2013

European firms need a new way to fund themselves away from banks. Europe's credit markets are centred around banks, and banks remain large at 3x GDP – still larger than in any other country in the world. This mode of banking and credit markets is obsolete. It's a model with large banks that retain risk on their balance sheets and encumber their assets with covered bond issuance. It is a model that works well with a low probability of failure, but high systemic losses in a crisis. But it is no longer suitable, as sovereigns cannot support bank funding, let alone recapitalise them.

More non-bank lending and capital markets help, but banks remain key for SMEs. Defending the old-style banking model is no longer possible, and regulators are increasingly shifting towards more capital markets funding. EC President-elect Juncker has pledged to strengthen capital markets following his election, and ECB President Draghi has discussed reviving asset backed securities. Several countries are trying to ease access to capital markets, including Holland, Finland and Italy which are promoting mini-bonds for mid-cap firms.

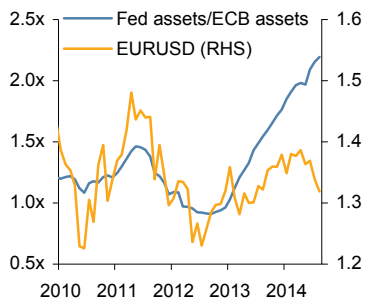
But most European firms are small, especially in the periphery, and unable to access capital markets individually. At the same time, banks remain unable to lend aggressively, after deleveraging by €4tn in assets and by €573bn in loans since 2012, and recapitalising for the October stress tests. The charts below show banks are still cutting loans to non-financial firms, while SME loan rates in the periphery remain much more expensive than in core Europe.

Securitisation and risk transfer is a possible solution. A simple ABS structure can help banks to transfer risk and sell loans onto investors. This makes banks originators rather than the final risk-takers, at the same time allowing them to reduce risk and reduce their balance sheets and improve their capital/leverage ratios.

Yet, there are several obstacles to reviving the market. ECB members including Yves Mersch as well as Vítor Constâncio and Mario Draghi have been discussing a credit easing plan for over a year. But the problem remains that the existing ABS market is small and inactive. With inflation falling and core-periphery fragmentation still high, the likelihood of action is increasing, and credit easing could be a game-changer, as we have been arguing since over [a year ago](#). **What are the next steps and the challenges for the ECB? And are there any other solutions?**

2. Quantitative Easing and Credit Easing

The ECB must weaken the Euro CB assets vs currency



Source: RBS Credit Strategy, Bloomberg

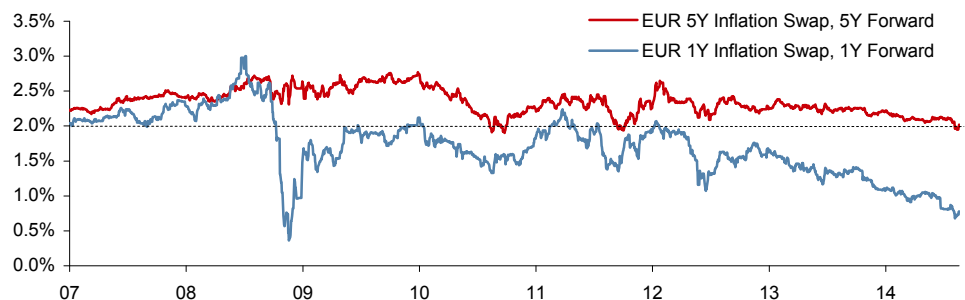
The ECB has two main unconventional levers to use. One is to buy sovereign debt to improve growth and inflation expectations (QE) and the other is to buy risky credit assets (ABS) to repair the transmission channel of credit (CE). The ECB has made it clear that QE of sovereign assets and an ABS purchase programme are two separate things, as Mr Draghi extensively discussed in [April](#):

“In our view an undue tightening of the policy stance can be addressed through a variety of more conventional measures. [...]”

Another contingency that would warrant a monetary policy reaction would be further impairments in the transmission of our stance, in particular via the bank lending channel. Given the reduction in bank funding costs over the last year and the ongoing clean-up of the banking sector through the comprehensive assessment, our assessment is that bank lending conditions are improving and will continue to improve. Yet if this scenario does not materialise, we may have to respond. This could take several forms, including a longer-term refinancing operation targeted towards encouraging bank lending or an **ABS purchase programme**, supported by the necessary regulatory changes aimed at revitalising high quality securitisation in Europe.

A third contingency would be a worsening of the medium-term outlook for inflation. [...] The objective here would not be to defend the current stance, but rather to increase meaningfully the degree of monetary accommodation [...] This would be the context for a more **broad-based asset purchase programme.**”

Inflation expectations continue to decline despite more expansive policy Euro forward inflation rates



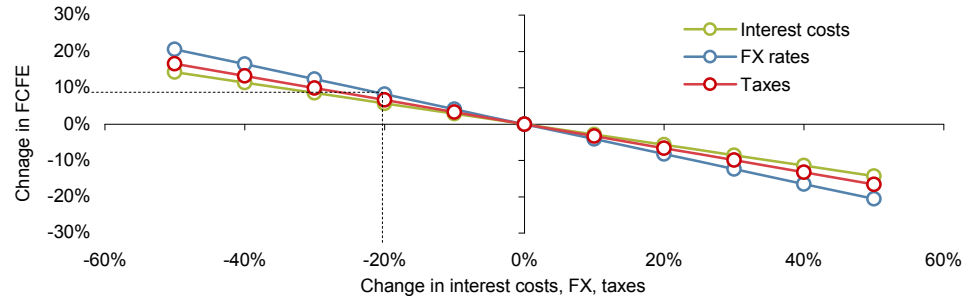
Source: RBS Credit Strategy, Bloomberg

The ECB now faces both the contingencies above: an impaired transmission mechanism of policy rates through the credit system (banks) to firms, which we think is unlikely to recover quickly post the TLTRO and comprehensive assessment, and a persistent decline in inflation expectations. There are two policy options going forward:

1. QE. To push up inflation expectations, the ECB could buy sovereign debt and potentially other assets (corporate bonds). This would also push the euro lower. The ECB's balance sheet has contracted by €1tn since the end of 2012, as banks have paid back their LTRO funding, while the Fed grew its balance sheet by around \$1.5tn over the same period. This has been a main driver of the Euro appreciation, which has in turn reduced Euro area inflation and growth expectations. A lower Euro would improve inflation expectations: our economists estimate that the 10% appreciation of the Euro since July 2012 has reduced consumer prices by 1-1.5% ([European Economics | Euro appreciation and Eurozone disinflation](#), 15 July 2014). It would also benefit SMEs and exporters in particular: we estimate that a 20% reduction in the currency (e.g. from 1.3 to 1.05) would translate into a 10% improvement in cashflows for an average periphery SME. Our European economist Richard Barwell analysed [the](#)

[anatomy of ECB QE](#) in several reports and think it may happen in Q1 2015, with just a [baby rate cut](#) of 10bp likely at the ECB meeting this week. Our rates colleagues also believe QE is highly likely and that will push yield levels even lower ([Draghi's steps towards QE](#), 26 August 2014).

Helping European SMEs: a lower currency and lower interest rates can boost cash flows
 Simulated impact of a % decline in interest rates and FX from current levels for periphery SMEs



Source: RBS Credit Strategy

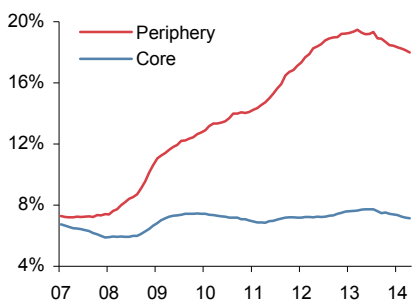
Yet, even with lower sovereign yields and a lower currency, obstacles to the transmission of credit through the banks will likely persist. The gap in core-periphery lending rates has declined (below), but is still wide. This will likely lead the ECB to pull the second lever:

2. CE. To reduce core-periphery fragmentation further, the ECB could support the revitalisation of the ABS market, buying risky credit assets linked to corporate lending and to SMEs in particular (Credit Easing). Despite the recent excitement, however, the practical obstacles to implementing an ABS purchase programme remain there. Last week the ECB announced the appointment of Blackrock Solutions as its consultant to design a plan. This is likely to take several months, making an announcement possible in December 2014 at the earliest, although the technical difficulties will likely limit both the potential size and breadth of the program. In addition to buying assets, the ECB and national regulators will also have to design the future ABS 2.0 instruments.

In other words, the ECB has two non-exclusive tools it can use: a broad-based QE of sovereign bonds and potentially other assets, to increase inflation expectations, and longer-term structural measures to revive the ABS market and repair the credit transmission channel. Both are possible, although at these sovereign yield levels, the emphasis should be on repairing credit transmission – but this also pushes the timing of any actions later into 2014.

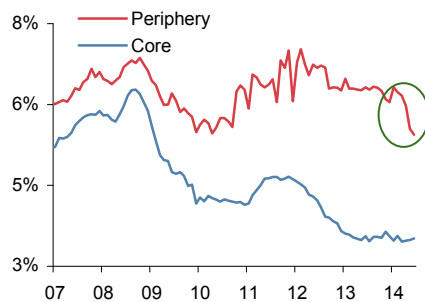
Here we focus on Credit Easing and ABS (2), and we aim to analyse some of the technical issues linked to potential policy actions.

Periphery unemployment is high
 Unemployment, %



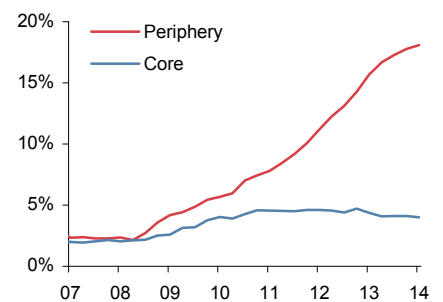
Source: RBS Credit Strategy, Bloomberg, Eurostat

Periphery firms pay more to borrow
 Interest rate on 1-5y loans under €1mn, %



Source: RBS Credit Strategy, ECB

Periphery NPLs may be peaking
 Non-performing loans, % total loans



Source: RBS Credit Strategy, Bloomberg

3. Benefits of ABS in the new regulatory regime

“So the final decision is to stand ready with a programme that would help to strengthen our accommodative monetary policy stance, injecting money into the real economy. And in so doing, it would lead to a reconstruction of a market that has disappeared with the crisis, also for good reasons. That’s why we are focusing our efforts on a market which would trade products that are, as I said on other occasions, simple, transparent and real. Simple, transparent and real. Simple means readable. Transparent means that you can actually go through and price them well. And real means that they are not going to be a sausage full of derivatives, as said in a somewhat more popular language.”

– Mario Draghi, President of the ECB, at the August 2014 [press conference](#) in Frankfurt

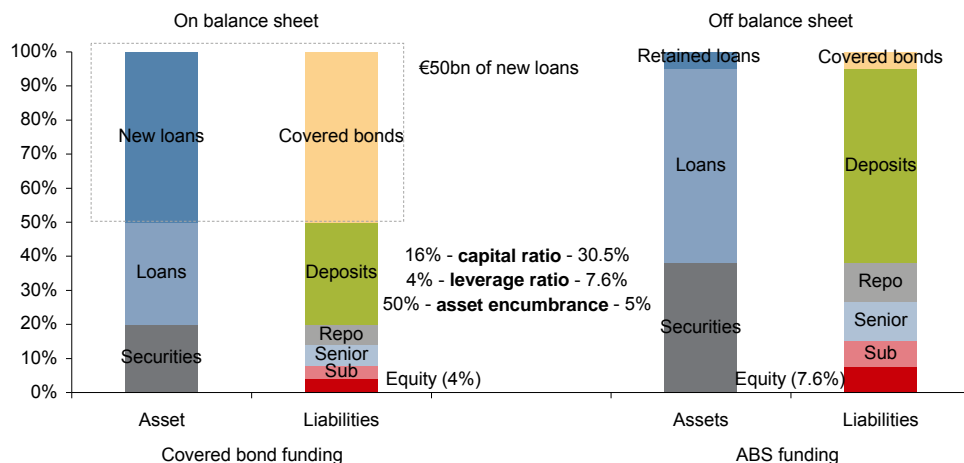
Asset-backed securities have been labelled as complex, risky and opaque during the crisis. Yet, regulators are now starting to reconsider them. Indeed, ABS could present several benefits for Europe’s banking system:

1. Funding with ABS vs covered bonds can improve capital, leverage and asset encumbrance/liquidity ratios for banks. We show this in the stylised balance sheet below: a bank that funds a 50% multi-year expansion in lending with ABS would have a 7.6% leverage ratio (vs 4%), a 30.5% capital ratio (vs 16%) and 5% asset encumbrance (vs 50%), compared to a bank that uses covered bonds.

2. Use of ABS can reduce risk for bondholders in a bail-in bank resolution regime. Bail-in of subordinated bondholders has become the norm for banks seeking state support, like SNS, HAA and BES. From 2016, senior bail-in will also come into effect under the Bank Resolution & Recovery Directive, which will force bail-in of 8% of liabilities for banks receiving state support. While covered bonds encumber assets and reduce recovery rates for unsecured bondholders, ABS instead increase the percentage of equity and sub debt in the balance sheet relative to the total balance sheet size. This could allow senior or even sub bondholders to have a higher buffer before the bail-in threshold.

3. Securitisations can make the transmission of monetary policy stimulus quicker during a crisis. The recent crisis has shown that transmitting easy policy rates into credit is not easy, if the banking system is crippled by lack of capital. The TLTRO may not work in the near term for that reason, as we explained in [The Revolver | TLTROnomics](#). ABS do not absorb substantial bank capital and, in an efficient market, their yields could be more closely linked to sovereign yield curves (like IG and HY bonds), in turn helping ECB policy to filter through lending rates.

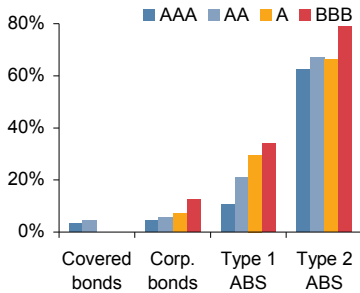
ABS can help banks improve their capital, leverage and liquidity ratios
Indicative balance sheet of using covered bonds vs ABS to fund an increase in lending



Source: RBS Credit Strategy

4. Challenges to an ABS recovery plan

Capital charges are high for ABS Solvency II capital charges, 5y notes



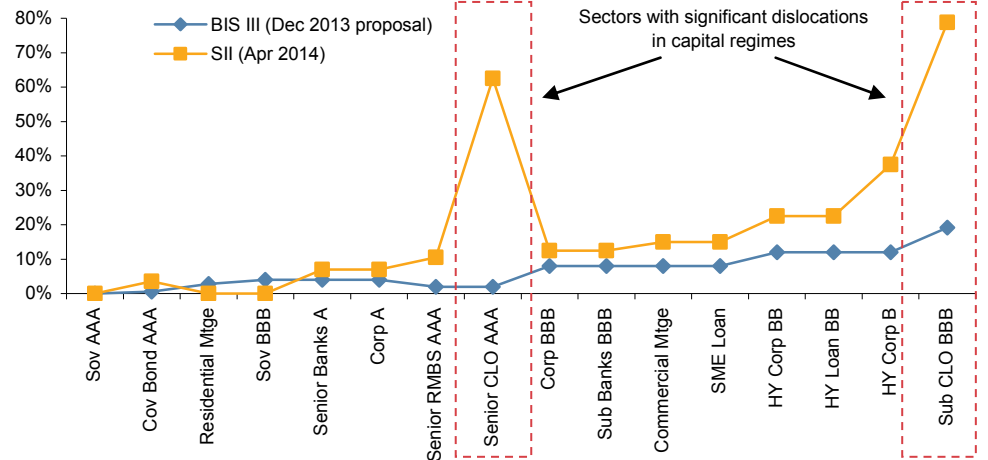
Source: RBS Credit Strategy, RBS ABS Strategy

There are significant technical and regulatory difficulties in reviving the ABS market. The ECB and BoE posed 18 questions in their [joint paper](#) on the challenges to an ABS programme (see [AFME's response](#)). We think the main economic, regulatory and technical obstacles are:

1. More restrictive capital charges could be the biggest impediment. Since the crisis, there has been a significant regulatory overhaul in the securitisation market. While most of the proposed changes are designed to better align the interests of the issuers and investors so as to reduce future financial stability risk, sometimes they can be overly harsh and discourage people from entering the market.

High capital charges under Basel III and Solvency II discourage investor demand. Despite some recent positive revisions, the latest proposed capital charges on securitisations under Basel III and Solvency II are still much more conservative than the previous regimes, and do not differentiate much with regards to the underlying collateral quality. Such high capital costs act as a major deterrent to European banks and insurers from holding securitised products. As a result an [IMF policy report](#) points out that insurers and banks get higher returns by holding the underlying SME loans rather than SME-backed securitisations. In addition, ABS are also treated unfavourably in the calculation of the Basel III Liquidity Coverage Ratio. Currently only a small portion of RMBS meeting certain criteria can be classified as High Quality Liquid Assets (HQLA). This again limits banks' incentive to hold securitised products.

High risk weights on retained tranches limit holding capacity from insurers and banks Capital charges under standardised approach for Basel II and III



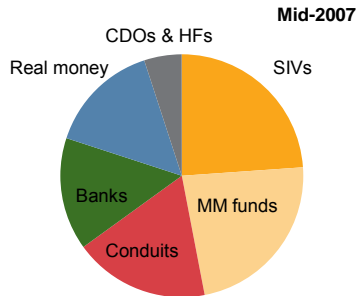
Source: RBS Credit Strategy, RBS ABS Strategy, BIS, EIOPA

Risk transfer and risk retention. For issuing banks, a major incentive/benefit to issue ABS is to transfer credit risk to investors and achieve capital relief. Banks need to demonstrate that a transaction involves a significant risk transfer (SRT) to claim capital relief (see EBA [final guidelines](#)). However, with the introduction of the 5% "skin-in-the-game" retention rule, banks must retain part of the securitisation or the underlying assets. Some banks have been able to comply with the 5% retention rule guidelines by retaining part of the *original pool* of loans, where the securitisation was randomly drawn from. The rationale for the rule is to align banks' interests with investors and prevent information asymmetries, which in the past led to the subprime crisis. Other ways to reduce information asymmetry, especially for new entrants, would be to increase the availability of loan-level data like the Banque de France's [rating system](#) to the public.

2. The investor base has shrunk and is now made of real money asset managers, but insurers and banks are still out of the game. The shrinkage is both due to the unfavourable regulatory shifts discussed above and changes in investors' risk

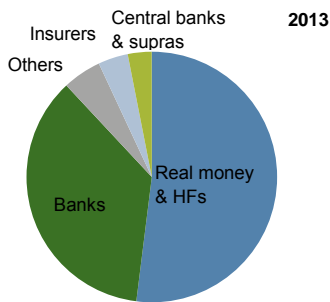
assessment of the asset class since the crisis. Some regulators have encouraged investors to buy securitisations (e.g. IVASS in Italy recently allowed insurers to put 5% of their reserves in securitisations). Yet, it may be hard to attract insurers and banks back to the asset class.

Before: banks and insurers
ABS investor base, mid-2007



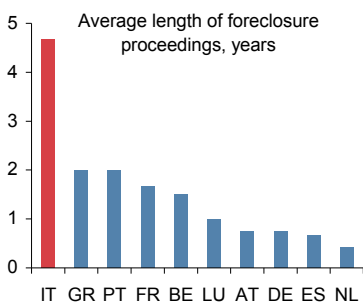
Source: RBS ABS Macro Strategy

Now: asset managers own most
ABS investor base, 2013



Source: RBS ABS Macro Strategy

Bankruptcy laws: widely different
Italy lags Europe on length of cases



Source: RBS Credit Strategy, ECB

3. Lack of information and infrastructure are barriers to entry for new issuers.

The European securitisation market is still dominated by bank issuers. As the ECB and BoE paper suggests, a well-functioning market should also involve more non-bank financial institutions. However, non-bank lenders may lack the infrastructure needed to become active players in the market. In particular, SME securitisations require a large pool of diversified company loans, which non-banks may find hard to amass. Given the heterogeneity of SME loans, issuers often need granular loan-level data and credit history to assess risks during the structuring process. Non-bank lenders often do not have access to such data, and banks (and companies) may be unwilling to share it. Again, the publication of loan-level data or ratings may reduce information asymmetries even in this case, opening up the market to non-bank lenders.

4. Lack of a level playing field in disclosure and bankruptcy laws segments the market across jurisdictions.

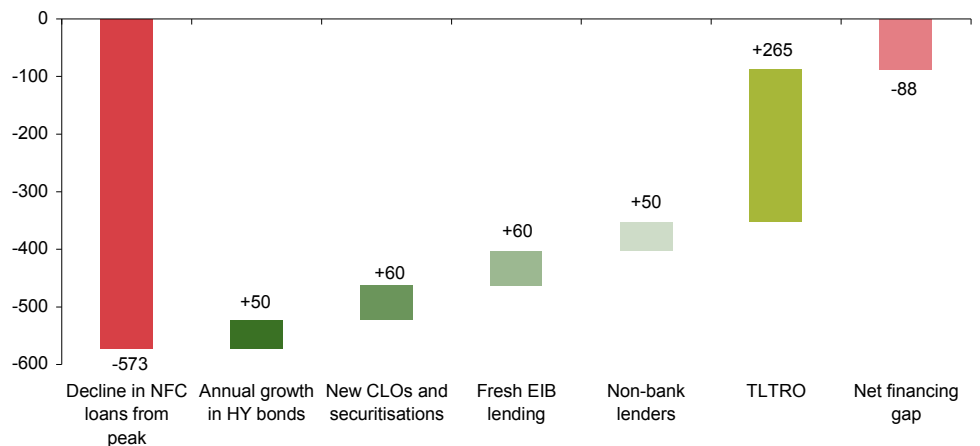
Central banks have worked to standardise reporting and to improve data availability, for example through the European Data Warehouse. Both the ECB and BoE have introduced standardised loan-level reporting requirements for ABS to be accepted as eligible collateral. But these do not cover the whole market and investors still lack information, as discussed above. Moreover, while the reporting templates are standardised, the underlying loan markets across Europe are not. There are substantial variations between European countries in terms of underwriting standards, default definitions and bankruptcy procedures: it takes 5-10 years to foreclose in Italy vs less than a year in Spain. This strongly affects the expected return for investors. Levelling the playing field on reporting standards, bankruptcy laws and timing of recovery on bad loans is a fundamental long-term challenge.

5. Sovereign rating caps may require EU-level support (EIB/EIF) for issuance.

Credit rating agencies like Moody's and S&P post crisis require higher credit enhancement for structured products to achieve certain ratings. ABS in some European countries are also subject to rating caps based on sovereign ratings. These structured products would require additional guarantee from institutions like the EIF or EIB to achieve higher ratings even if the quality of their collateral is good. The EIB has been boosting its lending programmes across the euro area to around €60bn annually, but this is still a small amount vs the lending gap created by the retrenchment of banks during the recession. The ECB will likely need more cooperation from fiscal authorities.

How securitisations could help to close Europe's lending gap

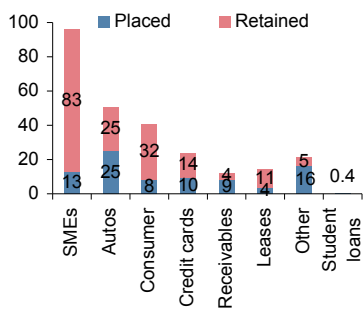
From the left: decline in NFC loans since crisis (€bn), and potential offsetting effect from non-bank sources of lending and TLTRO lending over a 2-year period



Source: RBS Credit Strategy, ECB

5. An ABS purchase programme in practice

ABS by sub-sector: still small
Amount outstanding, €bn



Source: RBS Credit Strategy

What can the ECB buy? President Draghi said the ABS programme will be “*real economy-oriented, oriented towards non-financial companies of the private sector*”. A programme could target all sub-sectors of ABS, including consumer loans (on the lines of the TLTRO, which includes consumer lending, but not mortgages). It is possible the ECB may also target RMBS and CMBS, if it decides to follow the broader securitisation market.

Will the programme focus on new or only existing assets? In theory, it should focus on new-generation ABS instruments. But issuance remains low and to encourage primary markets, the ECB is likely to target a proportion of the already placed assets.

How big would an ABS programme be? There are €300bn of total ABS in Europe, according to SIFMA, including SMEs and other sub-sectors. Around two thirds is “retained”, i.e. sits on bank balance sheets, one third is “placed” or in circulation. We think the ECB will likely look at both placed and retained ABS. In any case, a potential programme would therefore have to start small (<€100bn) and work over a period of several quarters. To achieve a larger size, the ECB could potentially buy RMBS and CMBS too, which represent 70% of the €1.4tn market, although this may affect housing markets, something that the ECB has avoided in the TLTRO.

How will the ECB distribute purchases geographically? In its covered bond programme, the ECB distributed purchases according to the size of the respective market segments. For ABS, it may not be possible to buy proportionally across countries, given the uneven distribution of the market. There are €29bn of placed ABS in Germany (34% of the €85bn total), €10bn in Spain, €9bn in Italy and €6bn in France.

Will the ECB buy senior tranches or also mezzanine? Senior tranches will fall easily into the ECB’s remit given their low-risk characteristics. However, banks enjoy capital relief and accounting de-consolidation benefits only by selling the lower tranches too (a so-called “full stack” or “fully placed” securitisation). To achieve this, the ECB may support demand for mezzanine too, like the BoJ did in 2003-2005. Our ABS trading desk strategists think that an ECB programme could spur more issuance of full-stack securitisations than at any time in recent memory ([ABS Comeback Milestone? An Update](#), 18 June 2014).

Will purchased ABS require sovereign guarantees? We think the ECB could buy senior tranches without guarantees, given the low historical probability of default. Governments could guarantee mezzanine tranches, perhaps via their national development banks (ICO, KfW etc.). The EIB currently appears reluctant to do so.

How will purchase operations work? We see four potential ways how the ECB could execute an ABS purchase programme:

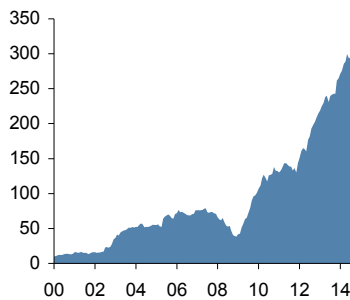
1. Buying tranches outright
2. Buying through asset managers on a mandate
3. Offering guarantees to investors a la TALF
4. Funding a bank to invest in ABS tranches

When could the ECB start buying? Given technical complexity, probably in Q1 2015 at the earliest, but an announcement could come late this year (December 2014).

Conclusion: no quick bazooka, but a structural plan. In short, an ABS plan would have to take a “*build it and they will come*” structural approach for a new market, as our European economist Richard Barwell called it, quoting Kevin Costner’s [Field of Dreams](#) film ([ECB Preview | On message?](#), 1 August 2014).

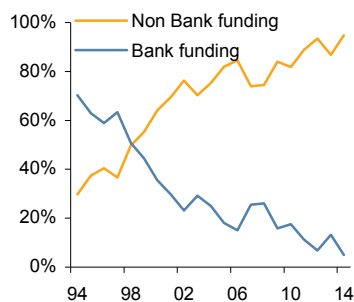
6. Besides ABS: Expanding capital markets

HY bond markets are growing Euro high yield market size, €bn



Source: RBS Credit Strategy

Europe needs more bonds, like US US shift from banks to bonds and leveraged loans, % corporate credit



Source: RBS Credit Strategy, Deloitte

There are other instruments that offer alternatives to bank lending:

1. Bigger bond markets. European high yield bond markets have grown 2.5x in the last 3 years and more than 20% in the last year. 2014 has also been a record year for issuance, which year-to-date is €130bn (gross). However, the Euro market is still smaller than the US high yield market, which is more than 3x the size at \$1.35tn. In Europe firms typically fund about 20% of their debt with bonds vs 80% in the US.

2. Non-bank institutional lenders. Lending from non-bank investors like asset managers and insurers is growing rapidly. Some are entering the loan market in partnership with banks, for example BlueBay with Barclays and AXA with SocGen, others directly. [Deloitte's Alternative Lender Deal Tracker](#) tracks deals under £300/€350mn to mid-market firms: the UK accounts for 47% of the market. Non-bank loans rose 50% YoY in the UK and 120% in the rest of Europe in Q1.

3. National and EU development banks. Development banks lend to small businesses through a number of programmes. At the European level, the EIB lends around €60bn a year to firms through partnerships with local commercial banks, often lending more than 50% of each loan. Together with the EIF, it has lent €22bn to SMEs across Europe in the past year. The EIB also participates in securitisations, buying €145.8mn (97%) of an Italian water company mini-bond ABS transaction, and also buying €97bn of ABS backed by SME leases issued by IKB Leasing last month.

Development banks could also play a role in an ABS purchase programme. ECB Board member Lautenschläger said that governments, via national development banks, could guarantee risky ABS tranches as part of a programme. The EIB could also fulfil this role, thereby also reducing core-periphery fragmentation. The EIB does this on a small-scale through its €2.3bn COSME programme, but is reluctant to do so for large-scale ECB purchases, as its President has said ([MNI News](#)). EC President-elect Juncker aims to expand the use of the EIB and EU funds to support SMEs and create €300bn additional investment over the next 3 years, including through loans and guarantees. Greece's government will subsidise loans to 35,000 SMEs using EU structural funds.

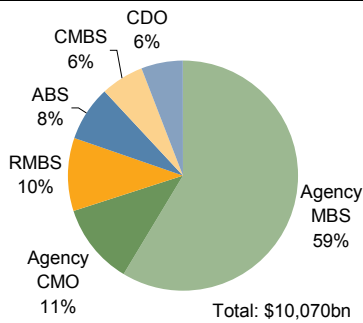
4. Mini-bonds. Mini-bonds exist in many countries, including the UK, Finland, Holland and Italy. Governments have tried to increase firms' access to bond markets recently. Holland launched a €1bn entrepreneurs' mini-bond fund in January with support of Euronext Amsterdam. Italy approved tax incentives for SMEs to issue mini-bonds with Monti's "development decree" in 2012 and Renzi's recent "unblock Italy" bill. The Italian Stock Exchange also created mini-bond trading platform Extra MOT PRO last year. Italian firms have issued €1bn of mini-bonds over the past 2 months. [Pioneer Investments](#) and [BNP](#) recently set up Italian mini-bond funds. Greek stock exchange Athex is also promoting mini-bonds, allowing companies to issue mini-bonds of up to €5mn through its ENA STEP "support the entrepreneur" programme ([Reuters](#)). Some issuers are taking this further and are securitising mini-bonds. 8 Italian local water companies recently issued a €150mn ABS backed by mini-bonds ([Reuters](#)). Similarly, Athex wants to expand its SME mini-bond programme through securitisation.

5. SME CLOs. Even though traditionally used for leveraged loans, CLOs can also be used to fund SME secured debt, as some recent deals have shown (see below).

6. Alternative platforms. Crowdfunding and peer-to-peer firms like [Funding Circle](#) are growing, although they remain a relatively small (<1%) part of the loan market. Alternative lenders have provided over £1bn of loans to date, but are likely to grow further. UK Chancellor Osborne this month announced a proposal to force banks to refer SMEs they reject for loans to other banks and alternative lenders via an online platform ([FT](#)), while the EU has recently pledged [support](#) for crowd-funding.

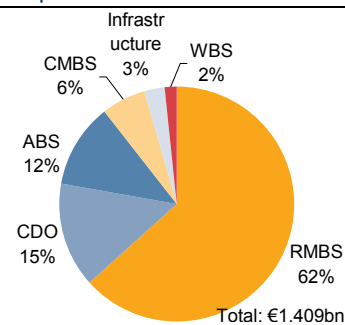
7. Overview of Europe's securitisation market

Agency MBS dominates the US US securitisations outstanding



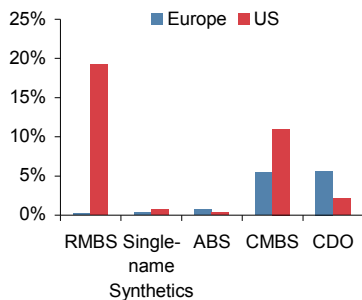
Source: RBS Credit Strategy, SIFMA

Europe has a much smaller market European securitisations outstanding



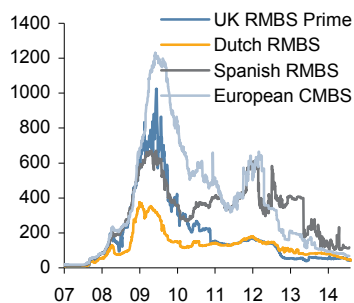
Source: RBS Credit Strategy, RBS ABS Macro Strategy

Default rates are lower in Europe Default % at the end of 2012



Source: RBS Credit Strategy, S&P

Spreads at lowest level post-crisis 3-5Yr spreads (bps), AAA/AA rated



Source: RBS Credit Strategy, RBS ABS Macro Strategy

With €1.4tn of securitisations outstanding according to SIFMA data, the European securitisation market is about one fifth of the size of the US. And while the US market is dominated by agency securitisations (70%), there is no European equivalent. The most dominant product type is Residential Mortgage-Backed-Securities (RMBS), which accounts for around 60% of the market, followed by Collateralised Debt Obligations (CDOs) and asset-backed securities (ABS). European securitisations generally have less complex structures and better ratings. Issuance dropped to €181bn in 2013, -78% from its 2008 peak, while it remained relatively strong in the US during the same period.

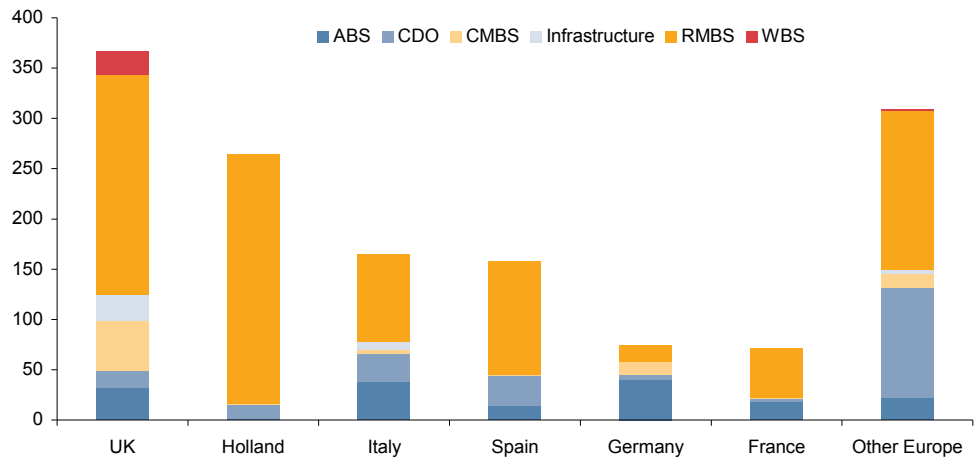
European structured finance has been more resilient and saw fewer defaults during the crisis. According to [S&P](#), only 1.5% of structured notes (by original issuance volume) outstanding in mid-2007 had defaulted by the end of 2013 vs 18.4% in the US (including sub-prime loans).

The mortgage-backed segments of the securitisation market include:

RMBS: UK and Dutch RMBS dominate the market, with outstanding securitisations at €118bn and €75bn respectively. UK RMBS has been benefiting from lower interest rates, funding for lending schemes and faster growth. However, rapidly rising house prices and potential rate hikes next year could affect the affordability for future buyers. Dutch RMBS is also performing well so far thanks to continued mortgage support from the government through the Nationale Hypotheek Garantie (NHG) programme. According to [Moody's](#), the 90+ day delinquency rate of Dutch RMBS is low at 0.75% in June 2014. UK prime RMBS and Dutch RMBS AAA spreads are trading at around 45bp, the lowest levels post-crisis (left). Italy and Spain in the periphery are also major players in the RMBS market: together they account for 23% of total outstanding securitisations in Europe. Italian and Spanish RMBS markets are showing signs of stabilisations although their 90+ day delinquency ratios are higher at around 1.7%.

CMBS: Germany and the UK together comprise over three-fourths of total outstanding CMBS in Europe (€79bn). CMBS performance in the two countries is benefiting from releveraging activity as the two economies are recovering. Italy still accounts for 6% of total outstanding CMBS in Europe and has also been active in issuance this year. European CMBS triple-A spreads are trading at the lowest levels since the crisis, at around 70 bps now vs as high as 1200 bps during 2009 (left).

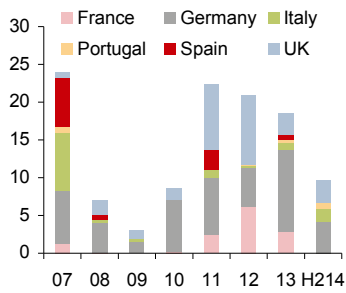
RMBS dominates the market in the UK, Holland and Spain, while Germany has more ABS European securitisations outstanding, €bn



Source: RBS Credit Strategy, RBS ABS Macro Strategy

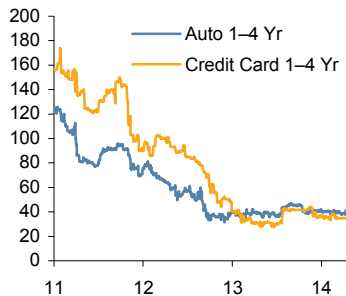
7.1 The European ABS market and its sub-sectors

ABS issuance rising in periphery ABS issuance, €bn



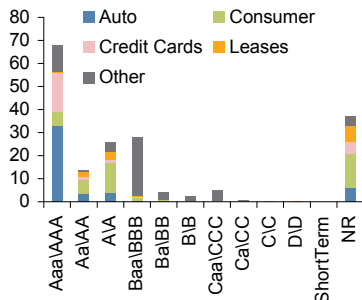
Source: RBS Credit Strategy, RBS ABS Strategy, Concept ABS

Spreads continue to tighten Auto & credit card 1-4Y spreads, bps



Source: RBS Credit Strategy, Markit

Auto ABS has better ratings ABS outstanding by ratings, €bn



Source: RBS Credit Strategy, SIFMA

The European ABS market has around €300bn of placed and retained securitisations outstanding, according to [SIFMA](#), including SME ABS and other sectors. SME loan securitisations (including SME CLOs and SME CDOs) are around €108bn in total. Other ABS are mostly backed by auto loans (25%), consumer (23%) and credit cards (14%). Both ABS and SME securitisations together are small compared to the €573bn of non-financial corporate and consumer loan deleveraging that European banks have undertaken since the crisis. That said, ABS have shown some signs of recovery in primary and secondary markets.

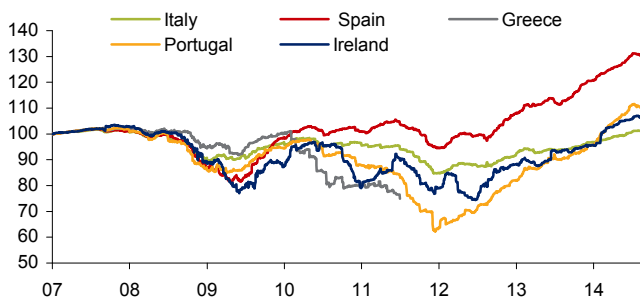
Issuance and secondary prices are recovering in the periphery. According to data from our ABS trading desk strategists, total placed ABS issuance this year was €11bn till Q2. Germany has been the biggest issuer with €4.1bn of issuance, followed by the UK (€2.9bn). Among periphery countries, Italy and Portugal have been the most active this year with ABS issuances up by 82% YoY to €1.8bn and 67% YoY to €0.8bn respectively. This is a positive sign in our view, although the amount is still low as compared to historic levels.

In secondary markets, prices have continued to recover since 2012 on ECB support discussions. Portugal's iBoxx ABS index is up by 14% YtD, Ireland by 11%, Spain by 8% and Italy by 4%. YtD returns for Germany and France are slightly below 2% while UK is slightly better at 4%. Markit data also shows that auto and credit card 1-4 Yr ABS spreads have tightened significantly since 2011 (shown left) and are trading below 40 bps.

Autos are the largest segment of outstanding ABS, with €25bn placed securitisations and €8bn issuance YtD. RCI Banque, Santander and Volkswagen were the most active originators in Q2 2014. Performance of ABS securitisation market has been robust so far thanks to a broad-based recovery in Europe. Unemployment is starting to decline from previous highs and consumer confidence is gradually picking up (excluding the past few weeks). According to [ACEA](#) data, new passenger car registrations are increasing across EU countries (+6.5% YoY in Q2 2014) especially in Spain (+18%) and the UK (+11%). Italy's new passenger car registrations are also posting positive growth (+3% in Q2 2014) after three years of decline. Auto ABS will continue to benefit from low interest rates, increased car registrations, higher used car prices and lower delinquency ratios.

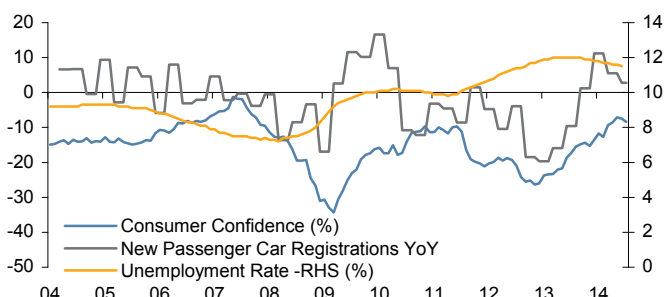
Consumer loan ABS have around €8bn of placed securitisations and is mostly distributed across Greece, Italy, France and Netherlands. The consumer loan ABS market has been inactive during 2008-2010, with no new placed issuances. However, there are some signs of recovery as consumer confidence, unemployment rates and retail sales have gradually improved across the euro zone post-crisis. Current YtD placed issuance stands at €1.8bn, already close to last two years' average issuance of €2.2 bn.

Portugal and Ireland ABS index up by 14% and 11% YtD Markit iBoxx ABS Index EUR



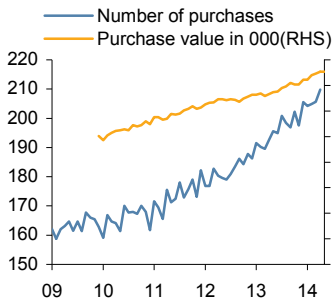
Source: RBS Credit Strategy, Markit

Improving economic outlook will benefit the auto ABS market New car sales YoY growth (%) vs macro indicators



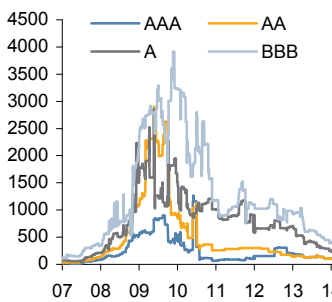
Source: RBS Credit Strategy, Bloomberg

UK credit card market is growing
Credit card purchases



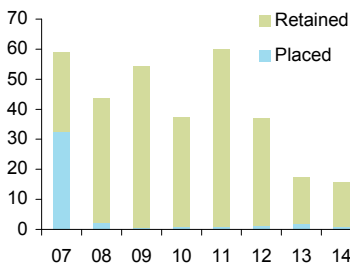
Source: RBS Credit Strategy, Fitch

CLO spreads have tightened
bp



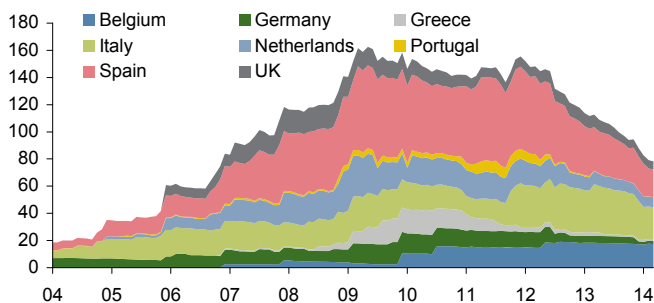
Source: RBS Credit Strategy, ABS credit strategy

Retained vs placed SME deals
Issuance, €bn



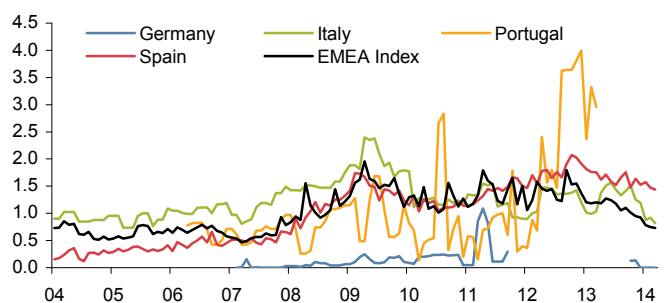
Source: RBS Credit Strategy, ABS credit strategy

Italy, Spain and Belgium have the highest outstanding amount
SME securitisations outstanding by country (€bn)



Source: RBS Credit Strategy, Moody's

SME delinquency ratio (60-90 days) has come down
%



Source: RBS Credit Strategy, Bloomberg

Credit Card ABS are around €10bn (placed), mostly in the UK with AAA ratings. They are expanding at a slower pace in Europe as compared to the US as lending remains weak, especially across the periphery. However, demand in the UK market is robust as its economy is growing at one of the fastest pace in developed economies and unemployment is falling. According to [Fitch](#), the number of UK credit card transactions was higher by 9% YoY for the Jan-May period although the spending per card didn't increase much. The 60-80 day delinquency rate has fallen to its lowest level at 1.2% in Q2 2014.

Leasing is a very small share in the ABS market with €3.6bn of placed securitisations. The Italian leasing market contributes around 50% of total securitisations. Issuance in this sector was also muted during the 2009-2012 period, but this year placed issuance stands at around €0.6bn.

SME securitisations are around €108bn, according to SIFMA. However, most of these are retained by the originating banks as collateral for central bank liquidity. According to data from our ABS trading desk team, only €13bn of SME CDOs are placed with investors. Harsher regulatory treatments and negative stigma attached with securitisation products have also made it more difficult for the originators to place them. However, SME securitisations are likely to be a key focus for the ECB programme. Either direct purchases or the development of a "qualifying SME ABS" could lead to further spread tightening and promote investor demand. A recovery of the SME securitisation market in our view will be particularly beneficial to periphery countries, where SMEs are the backbone of their economies (e.g. Italy and Spain).

CLOs offer attractive yields but are unlikely to be promoted in the ECB's upcoming asset purchase program. The leveraged loan CLO market has €68bn of placed securitisations, according to data from our ABS team. BBB and A rated 3-5yr CLO spreads are trading at 250 and 400bp (shown left). With ABS and RMBS spreads at all time lows, CLOs appear attractive in our view. However, higher capital charges under Basel III and Solvency II rules along with the 5% retention rule for the sponsor will act as an impediment to the CLO market. Given their more complex nature, CLOs are also unlikely to be promoted by the ECB explicitly. Having said that, CLOs could still benefit indirectly from any ECB actions in the ABS market, and spreads have already tightened on recent discussion of a potential programme. There have been new deals too, including in the periphery – we describe two examples above.

Liquidity remains scarce despite the recent rally in prices. Of course, one common characteristic of all sub-sectors is low liquidity, which remains low despite a rally in prices following discussion of ECB involvement. In spite of the excitement, we are still far from a well-functioning market.

7.2 Recent signs of life in ABS, CLOs and mini-bonds

Below are some examples of recent innovative transactions:

SME loan securitisation: Geldilux is a €852mn securitisation of German SME loans issued in 2013. The loans are all between €50k and €3.5mn, disbursed in a single drawdown with a fixed interest rate, and bullet repayment after a maximum maturity of 368 days. UniCredit placed all five tranches to private investors, in contrast to the post-crisis trend of retained issuance. The €750mn Aaa-rated senior tranche was 88% of the total issuance, and came with a coupon of 1 month Euribor + 0.8%. This transaction is the twelfth SME securitisation by UniCredit since February 1999 ([press release](#)).

EIB-IKB Leasing: IKB sold €97mn worth of senior tranche (Class A notes) asset-backed securities to the European Investment Bank in August 2014 ([ABS loan for SMEs](#)). The securities are backed by German SME leasing receivables originated by IKB Leasing. IKB Leasing will use the proceeds to fund other SME leases in Germany or other EU countries ([EIB signs deal with IKB](#)). This deal is one of the most recent attempts by the EIB to use the ABS market to provide more funding for SMEs as part of its COSME programme.

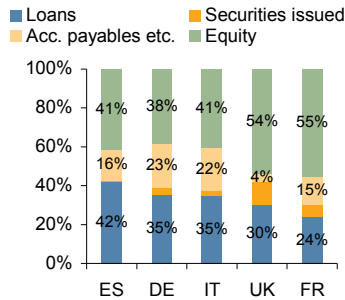
SME CLO Berica PMI. Banca Popolare di Vicenza issued in July 2013 the first Italian SME CLO to be partially placed with investors in recent years ([Fitch](#)). The transaction was a granular cash flow securitisation of a €1,569mn static portfolio of mortgage and non-mortgage loans granted to Italian SMEs. The originators were Banca Popolare di Vicenza and Banca Nuova. The €981mn senior component was split into two tranches: A1X (€980mn) and A1Y (€1mn). The senior tranches benefited from 43.2% credit enhancement and were rated AA+ with negative outlook by Fitch. Credit enhancement was provided in the form of subordination of non-rated class B notes, a cash reserve and collections received from the pool from 1 March to 1 June 2013. The €980m A1X senior tranche was sold to investors with a coupon of Euribor 3m + 240bp.

Securitisation of pooled SME mini-bonds in Italy. Eight Italian water companies from the region of Veneto have pooled their newly-issued mini-bonds as collateral for an asset-backed securitisation. The SPV, Viveracqua Hydrobond 1, issued €150mn of 20-year notes with a coupon of 3.9% in July 2014. €145mn of this were bought by EIB, with banks and pension funds acquiring the rest. The ABS is credit enhanced in two ways: a €6mn cash reserve provided by the financing arm of the Veneto region, and €24mn from mini-bond proceeds. The participating water utilities were: Acque del Basso Livenza, Centro Veneto Servizi, Acque del Chiampo, Alto Vicentino Servizi, Acque Vicentine, Azienda Servizi Integrati, BIM Gestione Servizi Pubblici and ETRA. The eight companies have unsolicited ratings from Italian credit rating agency CRIF, though the transaction itself is unrated. The deal was co-arranged by Finanziaria Internazionale and Veneto Sviluppo, who are looking to replicate the structure for other companies in other Italian regions and across Europe. The transaction made use of advantageous changes to Italian securitisation laws, which now allow for a wider range of assets to back ABS, as well as modifications to mid-cap financing rules. Ultimately, this transaction has provided the utilities with an alternative to bank borrowing and as such, could prove useful as an innovative template for boosting SME lending in Europe ([Reuters](#)).

RMBS: Credit Foncier de France issued the first French RMBS since 2006 on 27 May 2014 ([Bloomberg](#)). The €927.4mn deal had an €804mn senior component split into two tranches: A1 (€428mn) and A2-A (€376mn), rated AAA by Fitch. These senior notes were 2.7x and 3.5x oversubscribed, respectively. Credit enhancement totalled 13.4% of the securitised pool and was provided by the subordination of junior notes as well as a general reserve funded with the notes at inception. The deal also satisfied the 5% retention rule and hence CFF was able to achieve significant risk transfer and improve its leverage ratio.

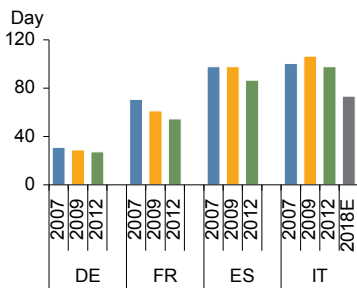
8. SMEs, Europe's economic backbone

Debt financing matters to SMEs SME capital structure



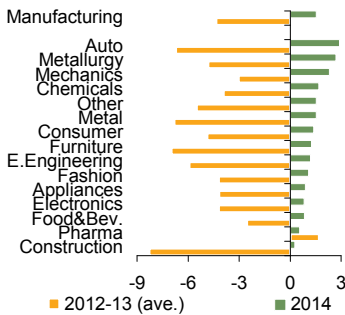
Source: RBS Credit Strategy, Bank of Italy

SMEs now wait shorter to get paid Average time to collect payments



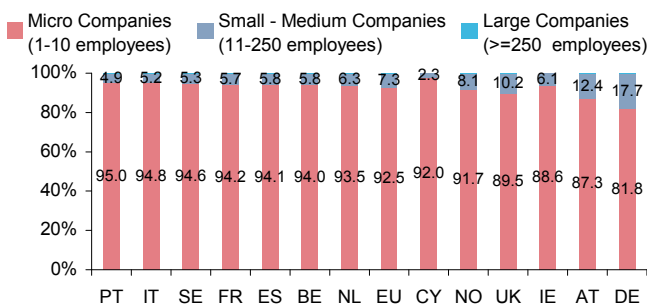
Source: RBS Credit Strategy, Prometeia

Italian firms are recovering Turnover in constant prices, %Δ YoY



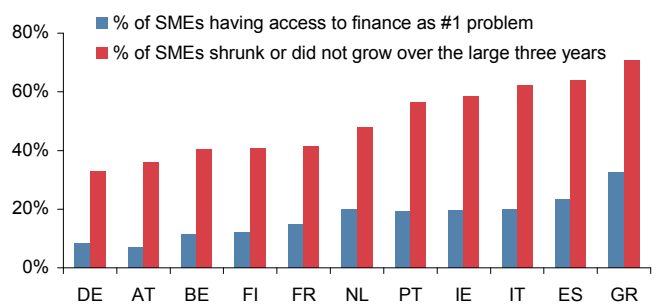
Source: RBS Credit Strategy, Prometeia

SMEs play an important role in Europe's economy Breakdown of companies by size, % of total companies



Source: RBS Credit Strategy, Eurostat

Lack of access to finance is hindering SME growth % of SMEs having finance problem vs growth problem



Source: RBS Credit Strategy, ECB SME Survey

SMEs form the majority of the real economy in Europe, but have been slow in recovery from the crisis. Small firms create around 70% of total employment and 60% of economic value added in Europe, according to Eurostat. While hit equally hard by the crisis, SMEs have been recovering more slowly than large firms, according to the EC's [2013 SME report](#). **Cyclical factors could explain part of the slow recovery, but European SMEs also face other more structural challenges:**

1. Tighter credit conditions: Loans are an important financing source for SMEs in Europe (left). However, bank deleveraging have made it harder for them to get credit. Limited access to credit has created liquidity problems for SMEs and is hindering their growth. As shown below, there is a clear correlation between the % of SMEs having financing difficulties and the % that shrunk or did not grow over the past three years.

2. Punitive bankruptcy regimes: An efficient bankruptcy regime should encourage early restructuring of viable firms that are in temporary hardships and liquidation of the nonviable ones. However, bankruptcy laws in some European countries had been unduly harsh to small firms and often entailed unlimited liability on owners. For example, Italy only introduced Chapter 11-style bankruptcy protection for SMEs in 2012. Spain only legislated to allow debt discharge for non-corporates in late 2013.

3. Institutional burdens: As an [EC study](#) shows, firms in countries with more administrative requirements on permits, regulations and taxation tend to grow more slowly. While most European countries have been working on reducing such burdens, some regulatory disincentives for small firms remain. For example, France has over two times more companies with 49 employees than with 50, according to the CGPME, which is likely due to additional regulatory obligations for firms with over 50 employees.

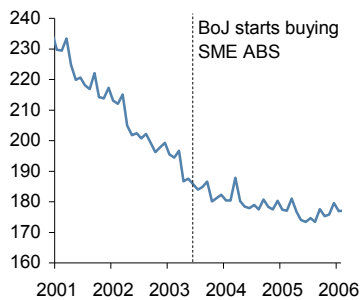
4. Slow public payments: According to the [EC](#), firms in Italy, Greece, Spain and Portugal on average wait between 133-170 days to get paid by public authorities. Such slow payments could negatively affect SMEs' liquidity positions and stifle their growth, as discussed by a recent [Bank of Italy paper](#).

There are more signs of improvements this year, but more support is needed. The percentage of SMEs that reported access to finance as the most pressing problem decreased to 14% in H2 2013 from 16% in H1 2013. Firms are also starting to see revenue growth, even in Italy where economic growth has been disappointing this year (left). Over the years, European SMEs have also improved cash flow management and reduced the average time of payment collection. However, recent data suggest that the recovery momentum in the Eurozone seems to be weaker than initially expected. Meanwhile, European banks have continued to cut loans to corporates. These again pose challenges for the SMEs' fragile recovery. Hence we think more support from the ECB and other public institutions, as well as more structural reforms are still essential.

9. A look at past programmes

Bank of Japan SME ABS purchases (2003-2005)

Japan: buying ABS helped a bit Japan bank lending to SMEs, JPYtn



Source: RBS Credit Strategy, Bank of Japan

The Bank of Japan bought small amounts of SME ABS from 2003: may have helped slow the contraction in lending slightly, but otherwise had little impact.

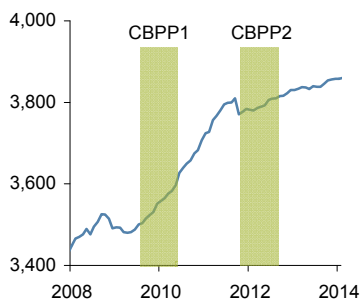
The Bank of Japan started a programme to buy up to JPY 1tn (then equivalent to around €7.5bn) of SME-backed ABS in 2003, as discussed in [Purchase of SME-related ABS by the Bank of Japan](#).

What did the BoJ buy? The BoJ bought the mezzanine tranches with ratings higher than BB of up to 3 years maturity, with the maximum purchase limited to less than half of the tranche; it did not buy equity tranches.

Did it work? The purchases seem to have had only a limited impact on credit. There appeared to be little impact on new ABS issuance: in the 6 months after announcing the programme in June, Japanese banks issued another JPY 653bn (€5bn) of new SME ABS vs JPY 1.1tn in the 6 months before (albeit with twice the number of deals), according to the paper. Lending by domestic banks to Japanese firms continued to contract for another two years, although the pace of decline did slow from around -8%/year to around -2%/year after purchases started, according to BoJ data shown left. Interest rates on new corporate loans did not appear to change materially, staying around 1.5-1.75% on average, according to BoJ data.

ECB Covered Bond Purchase Programme (2009-2012)

CBPP may have boosted lending Euro area mortgages, €tn



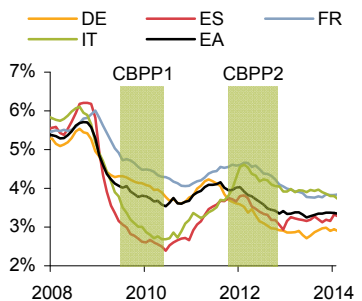
Source: RBS Credit Strategy, ECB

ECB purchases of covered bonds were small in scale but still gave modest support to the market and to mortgage lending. The ECB had two Covered Bond Purchase Programmes (CBPPs) to buy up to €100bn of covered bonds, out of around €1.6tn outstanding in the Euro area. It bought €60bn (nominal value) from July 2009 to June 2010 (CBPP1) and pledged to buy up to €40bn from November 2011 to October 2012 (CBPP2), although it only actually bought €16.4bn in the second phase. The ECB still holds €46.7bn of bonds from the two programmes.

What did the ECB buy? They bought covered bonds rated “AA” or higher, with minimum size of €500mn, mostly between 5-7 years. The ECB says it followed the market composition to allocate its purchases: *“The allocation of the CBPP to various segments of the covered bond market by and large shapes the characteristics of the portfolio in terms of financial risks. [...] Hence, the largest shares of covered bonds were bought in the covered bond market segments with the highest capitalisation.”* 27% CBPP1’s purchases and 37% of CBPP2’s purchases were in the primary market.

Did it work? The CBPPs helped to repair the covered bond market, particularly outside of Germany (which was already recovering). In its [review of CBPP1](#), the ECB argued that it pushed spreads down by 12bp across the Euro area, boosted issuance and repaired liquidity. The programmes also appeared to boost mortgage lending. Prior to the start of the first programme Euro area mortgages outstanding had been contracting, but over the course of the programme started to grow 4-5%/year, which continued for another year, as shown left. Mortgage lending started to slow prior to the second programme, and CBPP2 coincided with mortgage lending growing at a more modest pace of 0-2%/year, which has continued since then. Mortgage rates also declined during the programmes, helped by lower rates.

Mortgage rates fell during CBPP Mortgages rates, %



Source: RBS Credit Strategy, ECB

One downside of the CBPP was that it only helped to reduce bank funding costs – issuing covered bonds gives banks none of capital benefits that issuing ABS does. This may have limited the effectiveness of the CBPPs in boosting lending. In our view, this highlights how crucial it is for a programme to support not just senior but mezzanine tranches too, aiming at a recovery in full-stack securitisations which provide capital relief to banks. For this, however, the help of fiscal policy may be needed.

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Trade map: summary of trade ideas, country/sector and bank recommendations

	Core Europe	Semi-Core	Non-EMU	US	EM	Periphery					Overall
						Spain	Italy	Ireland	Portugal	Greece	
Ins sub		SG, Credit Ag, BNP, ING, ABN, KBC	Lloyds			Caixabank, Popular, Sabadell	Generali				OW 25%
Bank sub	Deutsche Bank, Commerzbank	Rabobank	SEB, Nordea, Handelsbanken, Swedbank, Danske								OW 30%
Bank senior	Deutsche Bank, Commerzbank, Erste, RBI	Rabobank	Barclays, HSBC, SEB, Handelsbank, Swedbank, Nordea, Danske			Popular, Sabadell	Intesa, Monte, Popolare	Bank of Ireland	Caixa Geral	Piraeus	OW 10%
Ins senior											OW 10%
Telecoms			BT, Everything Everywhere								OW 10%
			Telenor, Teliasonera, Ericsson								
Utilities	Fortum	GDF Suez, EDF									OW 10%
Fins Services											OW 5%
Industrials	Siemens		Rolls Royce				Atlantia	CRH			OW 5%
Cons Services		Publicis, Casino	Compass								UW -15%
Cons Goods		Unilever, Danone	BAT, Imperial Tobacco Nestle, Svenska Cellulosa, M&S, Morrisons, Tesco								UW -15%
Technology											UW -50%
Oil & Gas		Total, Shell	Statoil				ENI				UW -50%
Materials	Linde, BASF	DSM, Solvay	Holcim								UW -55%
Healthcare	Bayer	Sanofi									UW -75%
HY											Neutral
Overall	UW	OW	OW	UW	UW	OW	OW	OW	OW	OW	Neutral

Source: RBS Credit Strategy

Our views in bullets

Spreads. Geopolitical tensions and a potential hawkish shift in Fed policy could hurt \$, £ and EM credit, so we remain underweight. We are neutral on Euro credit, as it should be partly shielded thanks to continued ECB easing. We forecast investment grade spreads will be 50bp at year-end and high yield will decline to 200bp.

Default rates. We think default rates will fall to around 1%, on improving growth, stabilisation in unemployment and lending as well as a decline in the proportion of very low-rated companies. Default rates in the US instead will remain around 2%, on higher re-leveraging and shareholder-friendly activity.

Ratings. Ratings will gradually turn upwards for sovereigns on better growth, and later on for banks on new policies from the ECB, EIB and structural reforms to the banking system. Ireland, Portugal and Spain will benefit from positive rating actions.

Financials. We are long financials. We stay long periphery banks in senior debt on improving capital and liquidity as well as negative net supply of bonds, and long senior and sub debt in UK, France, Holland and Spain. Bank sub debt will continue to outperform this year, on ECB measures to strengthen banking system and more issuance of equity. We avoid banks that are dependent on investment banking and which trade too tight in core Europe and Scandinavia – which could face increasing regulatory risk. We also avoid banks which are exposed to EM, like in Austria.

Corporates. Periphery corporates offer a good premium to those in the rest of Europe. Larger companies with diversified revenues and stronger fundamentals will benefit as investors increasingly look to the periphery to capture this yield. We would avoid tight names in core Europe, as well as names in the technology and consumer cyclical sectors, including autos and retail. We prefer corporates which still need to deleverage, rather than core IG firms which have an incentive to re-leverage over the next year.

Capital structure. Banks' capital structures will change over 2014. Banks will continue to issue more equity and coco debt, particularly given regulators' increasing focus on the leverage ratio. We think the sweet spot will be LT2 debt. We are very selective on coco and hybrid bonds.

Regions. We prefer European periphery and semi-core; we avoid fake havens like Germany, Scandinavia, UK, US, Austria and Australia and are also underweight Emerging Markets. Euro credit will outperform US, and we forecast 5.9% and 8.5% total returns from European investment grade and high yield, respectively in 2014.

Duration. We prefer exposure to idiosyncratic and default risk vs systemic risk and volatility. Therefore, we recommend low/mid-range duration exposure to limit mark-to-market volatility, taking advantage of the positive impact of ECB liquidity and refinancing/tender activity, which is concentrated around the 3-7 year segment. This also allows investors to protect themselves from the risk of rising rates, which we see coming up in the US and the UK.

CDS-Bond basis. The positive basis collapsed to neutral across corporates during the latest rally in CDS, while it remains positive in financials. We think the CDS premium over cash could decline on positive policy risk.

Primary issuance. Issuance will remain strong on a gross basis, but flat or negative on a net basis on bank deleveraging.

Secondary volumes. Banks are de-risking trading and capital markets businesses as well as deleveraging loan portfolios. This means lower secondary volumes.

Our trades in bullets

1) Short Australia vs Europe. Australia's economy is too dependent on mining, construction and exports to a slowing China for growth, while the domestic real estate market also appears highly overvalued. Australian bank spreads do not price in these risks, in our view, and will widen as EM turmoil continues.

Buy protection on iTraxx Australia vs sell protection on iTraxx Europe.

2) Long single-A CLO senior tranches. European firms need to borrow but banks are still pulling back. This creates an opportunity for non-bank lending sources. CLOs are the easiest way for institutional investors to gain exposure to these loans and can provide the leverage needed to make the yields on lending attractive.

3) Sell EM-exposed corporates, buy European and US-focused firms. Sell corporates with revenues from emerging markets or EM-dependent products. Buy firms which will benefit from the US and European recovery.

Sell: Casino (COFP 3.994% 2020); Buy: Morrisons (MRWLN 2.25% 2020)

Sell: Holcim (HOLNVX 2.625% 2020); Buy: CRH (CRHID 2.75% 2020)

Sell: Telenor (TELNO 1.75% 2018); Buy: Everything Everywhere (EVEVRV 3.25% 18)

4) Sell EM-exposed banks, buy domestic banks. Sell banks which have sizeable operations in emerging markets and are vulnerable to a slowdown in EM growth. Buy domestic-focused banks which are exposed to the ongoing European recovery.

Sell: BBVA (BBVASM 3.75% 2018); Buy: Caixabank (CAIXABF 3.125% 2018)

Sell: Santander (SANTAN 4% 2017); Buy: Banco Popular (POPSM 2.5% 2017)

Sell: UniCredit (UCGIM 4.875% 2017); Buy: UBI (UBIIM 2.5% 2017)

Sell: HSBC (HSBC 3.125% 2017); Buy: Nationwide (NWIDE 3.125% 2017)

Sell: NAB (NAB 3.75% 2017); Buy: Lloyds (LLOYDS 1.75% 2018)

Sell: ANZ (ANZ 3.75% 2017); Buy: Lloyds (LLOYDS 1.75% 2018)

Sell: CBA (CBA 4.25% 2018); Buy: Lloyds (LLOYDS 1.75% 2018)

Sell: Westpac (WSTP 4.125% 2018); Buy: Lloyds (LLOYDS 1.75% 2018)

Sell: NAB (NAB 3.625% 2017); Buy: Lloyds (LLOYDS 6.75% 2018)

5) Sell EM-exposed Austrian Banks, buy domestic core banks. Switch out of EM-exposed banks into domestic banks.

Sell: Erste Bank (ERSTBK 1.875 05/13/19); Buy: BNP Paribas (BNP 2 01/28/19)

Sell: RBI (RBIIV 1.875 11/08/18); Buy: ING (INTNED 1.875 02/27/18)

Sell: UniCredit (UCGIM 3.625 01/24/19); Buy: Intesa (ISPIM 3 01/28/19)

6) Sell Core IG firms with the strongest incentive to re-leverage. Sell the firms which have the greatest incentive to re-leverage, based on five factors: 3y EBITDA growth, 5y EBITDA volatility, number of ratings notches above high yield, funding costs and our estimate of their optimal amount of debt.

Sell Statoil (STLNO € 2% 2020); Sell Royal Dutch Shell (RDSALN € 4.375% 2018)

Sell Telenor (TELNO € 4.125% 2020); Sell Sanofi (SANFP € 4.125% 2019)

Sell Total (TOTAL € 2.125% 2021); Sell Unilever (UNANA € 1.75% 2020)

Sell Nestle (NESNVX € 1.5% 2019); Sell TeliaSonera (TLSNSS € 4.25% 2020)

Sell GDF Suez (GSZFP € 6.875% 2019); Sell EDF (EDF € 5.375% 2020)

Sell ENI (ENIIM € 4.125% 2019); Sell Bayer (BAYNGR € 1.125% 2018)

Sell Publicis (PUBFP € 4.25% 2015); Sell Danone (BNFP € 2.25% 2021)

Sell Compass (CPGLN € 3.125% 2019); Sell Rolls-Royce (ROLLS £ 6.75% 2021)

Sell Linde (LINGR € 1.75% 2019); Sell Fortum (FUMVFH € 6% 2019)

Sell Svenska Cellulosa (SCABSS € 2.5% 2023); Sell Siemens (SIEGR € 1.5% 2020)

Sell Ericsson (LMETEL € 5.375% 2017); Sell BASF (BASGR € 1.5% 2018)

[The Revolver | Credit crunch, Phase III: A postcard from EM,](#)
5 February 2014

[Austrian banks: A dangerous waltz with emerging markets,](#)
21 February 2014

[Europe's corporates: Walking again, but not ready to run](#)
26 March 2014

Sell DSM (DSM € 1.75% 2019); Sell Solvay (SOLBBB € 4.625% 2018)
Sell Atlantia (ATLIM € 4.5% 2019);

[Eureka! Buy the Greecovery and Greek banks](#)

08 April 2014

7) Long Piraeus Bank senior. Greece is recovering and making progress on structural and budgetary reforms. Piraeus Bank has raised capital and is now resilient to further rises in bad loans or widening sovereign spreads.

Buy TPEIR 5% 2017

8) Short CDX EM vs long iTraxx Xover, to position for the *market impact* of higher rates.

9) Short Marks & Spencer, Tesco and Morrisons against BT, BAT and Imperial Tobacco, to position for the *economic* impact of higher rates.

Sell: MKS 6.125% 2021, TSCOLN 6.125% 2022, MRWLN 4.625% 2023.

Buy: BRITEL 5.75% 2028, BATSLN 7.25% 2024, IMTLN 8.125% 2024.

[The Exit Shock](#)

13 June 2014

Trade performance: Open trades

Open trade recommendations						
Trade	Start date	End date	Time horizon	Target Gain / Stop Loss	Total return	Revolver publication
European bank senior	6-Jul-12	Open			+1,177bp	H2 2012 Financials Outlook: Banking on Europe
European bank sub	6-Jul-12	Open			+379bp	H2 2012 Financials Outlook: Banking on Europe
Short Australia vs Europe	27-Jun-13	Open	6 months	+2/-1	+08bp	When the Fed and China sneeze again...
Buy single-A CLO senior tranches	20-Nov-13	Open	12 months	+6/-6	-	2014 Outlook: Europe's recovery
Sell EM-exposed corporates, buy European and US focused firms	5-Feb-13	Open	12 months	+2/-2	-16bp	Credit Crunch, Phase III: A postcard from EM
Sell EM-exposed banks, buy domestic banks	5-Feb-13	Open	12 months	+2/-2	+88bp	Credit Crunch, Phase III: A postcard from EM
Short Austrian Banks (EM exposed) vs Long Domestic banks	21-Feb-14	Open	12 months	+1.5/-1.5	+49bp	Austrian banks: A dangerous waltz with emerging markets
Sell Core IG releveragers	26-Mar-14	Open	6 months	+2/-2	+61bp	Europe's corporates: Walking again, but not ready to run
Long Piraeus Bank Senior	08-Apr-14	Open	6 months	+2.5/-2.5	+271bp	Eureka! Buy the Greecovery and Greek banks
Short CDX EM vs long iTraxx Xover	13-Jun-14	Open	6 months	+2/-2	+119bp	The Exit Shock
Short UK retail, long non-retail	13-Jun-14	Open	6 months	+1.5/-1.5	+151bp	The Exit Shock

Source: RBS, Bloomberg. Priced as of 29 August 2014
 Note: Mid-level spreads are used in performance calculations, and are not reflective of bid-asks for entering/exiting trades

Trade performance: Closed trades

Closed trade recommendations (2012-present)

Trade	Start date	End date	Time horizon	Target Gain / Stop Loss	Total return	Revolver publication
Buy 5-year senior CDS protection on Intesa, Societe Generale, and UniCredit. Buy a basket of cash covered bonds on the same names.	17-Feb-12	5-Apr-12	6m	+4/-4	+299bp	Liquidity today brings subordination tomorrow
Buy low-price, low-coupon bonds from cash rich firms.	5-Mar-12	12-Oct-12	3m	+3/-3	+294bp	The refinancing race is on: Buy bond tender candidates.
Buy protection on an equal weighted basket of Air France/KLM, Carrefour, Deutsche Post, IAG and Ineos. Sell protection on iTraxx Xover	12-Mar-12	2-Jul-12	6m	+2.5/-2.5	+40bp	After PSI: The threat of rising oil prices
Buying protection on BBVA, Caixabank and Santander vs selling protection on US and UK banks	19-Mar-12	29-Mar-12	3m	+2/-1	+208bp	Spain: Structural challenges deeper than liquidity can solve
Buy Bank of Ireland senior unsecured 4.625% € 2013 bonds	4-Apr-12	30-Oct-12	12m	+5/-5	+715bp	Ireland: The Celtic Tiger is coming back on track
Buy protection on BBVA 5-year senior CDS and sell protection on Santander	20-Apr-12	22-May-12	6m	+2.5/-2.5	+147bp	Stress testing Spain's champions: Sell BBVA vs Santander
Sell protection on Societe Generale 5-year senior CDS	30-Apr-12	21-Aug-12	6m	+3/-5	+325bp	France: Election fears overdone, long Societe Generale
Sell protection on iTraxx Xover. (Removed short leg of buying protection on iTraxx Sub Financials on 2-Jul-12.)	17-May-12	06-Aug-12	4m	+3/-2.5	+323bp	Greece: The fallout through the banking system
Short Australian banks against US corporates	24-May-12	31-Jul-12	6m	+1.5/-2	-229bp	The global repercussions of the Eurozone crisis
Sell protection on buy protection on Spain (1x:1x ratio)	1-Jun-12	29-Jun-12	6m	+3.5/-3.5	+336bp	Spain's near death experience
Buy short-dated bonds of downgrade-resilient periphery corporates. Sell downgrade-exposed periphery corporates	13-Jul-12	21-Aug-13	6m	+2/-2	+20bp	Investing on the edges of the market
Sell 5-year senior CDS protection on UniCredit and buy 5-year CDS protection on BBVA	20-Jul-12	6-Aug-12	6m	+3/-3	+205bp	Spain needs surgery, Italy therapy
Long European HY Corporates vs Xover	6-Aug-12	30-Oct-12	6m	+1.5/-1.5	+50bp	High yield: Still a buy, but be selective
Sell 5-year CDS protection on Fiat and buy protection on Peugeot and Renault	28-Aug-12	11-Sep-12	6m	+1.5/-1.5	+322bp	The Silk Highway: Long Fiat vs Peugeot & Renault
Short Spain vs Long Xover	3-Sep-12	30-Apr-13	6m	+2/-5	+61bp	Same problems, new mistakes: Sell Spain
Short Investment banks vs Long Commercial banks	3-Oct-12	24-Jun-13	6m	+2/-2	+14bp	Bank to basics: The future of investment banking
Buy short-dated Spanish sovereign bonds; sell short-dated BBVA senior bonds	12-Oct-12	14-Jan-14	6m	+1.5/-1.5	-81bp	Tail risk is dead, Long live tail risk
Buy BESPL 5.625% 2014 and sell PGB 3.6% 2014	17-Oct-12	08-Nov-12	6m	+3/-3	+291bp	Portugal: Long Banco Espirito Santo vs sovereign
Buy BASQUE 4.15% 2019, NAVARR 5.529% 2016, CANARY 2% 2016, CASTIL 3.85% 2016 and MADRID 6.213% 2016	29-Oct-12	7-Feb-13	6m	+16/-7	+1394bp	The Spanish regions: Mirage and oasis in a yield desert
Short LT2 bonds ISPIM 5% 2019, UCGIM 5.75% 2017, BPIM 6% 2020 and MONTE 5% 2020 vs Long iTraxx SubFin	10-Dec-12	28-Feb-13	3m	+5/-3	+115bp	Italy: Brace for political risk
Long Periphery Corporates	8-Jan-13	01-Oct-13	12m	+6/-4	+325bp	Top Trades 2013: Making money in a yield desert
Long Periphery Banks	8-Jan-13	19-Nov-13	12m	+6/-4	+487bp	Top Trades 2013: Making money in a yield desert
Long European vs US high yield	8-Jan-13	12-Dec-13	6m	+2/-2	+5bp	Top Trades 2013: Making money in a yield desert
Sell UK consumer bonds vs iBoxx 7-10 year £ BBB	29-Jan-13	16-Apr-13	7m	+3.5/-3.5	+200bp	The UK: slowly losing safe-haven status
Long Corporate Hybrid Bonds	19-Feb-13	14-Apr-14	6 m	+10/-6	+992bp	Corporate hybrids: another oasis in the yield desert
Short Italian bank sub vs Xover	14-Mar-13	28-Mar-13	6m	+2/-2	+472bp	The State of Credit Markets
Buy BESPL 2015 5.875% and CXGD 2015 5.625%	19-Apr-13	01-Oct13	6m	+3/-4.5	+104bp	Buy Portugal
Buy Mid Cap Periphery HY	23-May-13	19-Nov-13	6m	+6/-6	+438bp	High yield: Small is beautiful
Sell Monte 5% 2020 LT2	10-Jul-13	04-Oct-13	12m	+10/-10	+551bp	EC bail-in rules: It's time for a haircut
Buy top 30 deleveraging, sell top 30 releveraging credits	24-Sep-13	26-Mar-14	6m	+4/-4	+350bp	The leverage temptation resurfaces
Buy Protection on iTraxx Xover	01-Oct-13	11-Oct-13	1m	+1.5/-1.5	-117bp	Banking union: The moment of truth for Europe's banks
Long sub debt of French, Dutch and British banks	11-Oct-13	19-Nov-13	6m	+4/-4	+245bp	Melt-up: Going all-in into year-end
Buy Yankees	11-Oct-13	6-Aug-14	6m	+6/-6	+365bp	Melt-up: Going all-in into year-end
Buy sub debt of British, French, Dutch, Belgian and Spanish banks	20-Nov-13	6-Aug-14	12m	+6/-6	+581bp	2014 Outlook: Europe's recovery
Buy bonds of mid-cap periphery companies	20-Nov-13	6-Aug-14	12m	+6/-6	+729bp	2014 Outlook: Europe's recovery
Buy periphery senior bank debt	20-Nov-13	6-Aug-14	12m	+6/-6	+650bp	2014 Outlook: Europe's recovery

Source: RBS, Bloomberg. Note: Mid-level spreads are used in performance calculations, and are not reflective of bid-asks for entering/exiting trades

Recent research

[The credit liquidity trap](#) – 23 July 2014. Trading liquidity is evaporating out of bond markets. The recovery in credit has been about low rates pushing capital into risky assets and helping firms to refinance. This has made bond markets “the new banks”, providing most credit to the economy. But it has also pushed investors to take higher risks. What happens if low-for-long policy reverts and investors head for the exit? As regulators focus on banks, we fear that systemic risk is being left unchecked in financial markets. In this report we measure the decline in bond market liquidity, analyse the areas most exposed to a rapid sell-off, and discuss how yield hunters can avoid getting caught by the liquidity trap.

[Coconomics: Pricing contingent capital risks](#) – 3 July 2014. After supporting them to solve European banks’ capital gaps, policymakers have grown wary on contingent capital instruments: “investors are underestimating the probability that AT1 instruments will be required to absorb losses”, says the Bank of England in its latest Financial Stability Report, published last week. We have shown already that the coco market is dislocated, i.e. that market prices are not always reflecting the bonds’ features. In this Revolver, we create and explain a model to simulate banks’ earnings, and calculate conversion and cancellation risk.

[The Exit Shock](#) – 13 June 2014. Bond investors, prepare for Carneyage! Yesterday’s change in forward guidance by the Bank of England is a shot across the bow, but investors have not reacted. The Fed could follow suit over the coming months, as the benefits of stimulus become less evident vs its collateral effects – asset overvaluation, releveraging in credit markets and rising income inequality. The taper tantrum sent a shockwave through EM, HY and other high-beta products last year. It can happen again. Europe is less exposed thanks to the ECB’s aggressive stance, but not insulated: credit investors should prepare for the end of low-for-long, and its impact on spreads.

[TLTRONomics: Assessing the impact of the ECB package](#) – 6 June 2014. The ECB has beaten expectations, delivering as much as they could on:

1. Liquidity: rate cuts, end of SMP sterilisations, extension of the full allotment repo
 2. Liquidity-for-lending: a series of targeted LTROs (TLTRO) of around €400bn
 3. Asset purchases: discussion of a preparation for Asset Backed Securities purchases
- But whether the TLTRO will work in the real economy will depend on its economics and the take-up from banks. Will banks be able to use ECB liquidity to lend to SMEs? How much benefit will SME get from lower rates? We think the TLTRO will create some advantage, but its economics remain fragile for periphery banks. The good news is the ECB is still working on its bazooka – Credit Easing (CE) of asset-backed securities.

[H2 Outlook: Ocean’s 14 – the easy money has been made](#) – 22 May 2014. There is more risk and less upside in Europe, but it’s too early to sell. The next 3-4 months will be volatile. Eurosceptics are gaining ground at elections. Investors are fully pricing a large ECB intervention in June, but the bazooka may not be ready until post-AQR. After the end of tapering, the US and UK central banks will have to discuss how and when to exit stimulus. Finally, European bonds are no longer cheap vs fundamentals. That said, these fundamentals are improving, as corporates delever and banks strengthen their capital, and we think that after this volatility there will be more room for tightening later in the year. Investors should focus on the niches where there’s still some value: periphery, banks, high yield – avoiding the fake havens.

[Cocos: Investors call for standardisation, more consistency](#) – 12 May 2014. Like for British marmite, opinions on contingent capital differ wildly – some love them for the yield and the dislocations the market offers, while others dislike them and do not even consider them as bonds. But does everyone understand these products and their complexity? And what are the risks the market faces if a trigger event or a coupon deferral occurs? What should regulators do to make contingent capital more investable? We asked investors to share their views with a short survey, and over 150 responded – coco buyers and not. The results are exciting and worrying at the same time. We present here a summary of their thinking.

[Coco Loco: The systemic risks of contingent capital](#) – 14 April 2014. The coco market will grow to over €100bn this year. Coco bonds meet many needs: on the one hand, European banks need more capital, with just around 3% over assets vs 5-6% in the US and Switzerland. On the other, fixed income investors are hungry for yield and willing to take more risk. But are they pricing these risks correctly? We show that coco prices do not fully reflect the risks of conversion. And while performance is positive for now, lack of standardisation and complexity means any deferral or trigger will shake up the investor base going forward. We think investors should be selective.

[Eureka! Buy the Greecorecovery and Greek banks](#) – 8 April 2014. We initiate coverage on Greek banks today, with a long on Piraeus. There are still many obstacles for Greece. Its economy lost 24% of GDP during the crisis and public debt is 176% of GDP. One out of two young workers is unemployed. But there are signs of recovery, finally – in financial markets and in the real economy too. Manufacturing, tourism and even confidence are up. The Eurogroup and Germany are showing support and have discussed a third aid package. The budget is in surplus, allowing the government to distribute a potential €450m social dividend. Banks, hurt by bad loans and sovereign losses, have consolidated and are now raising capital.

[Europe's corporates: Walking again, but not ready to run](#) – 26 March 2014. There are more signs of growth in Europe and investors are rushing to put capital back to work in the riskiest parts of the bond market: periphery, hybrid capital, and high yield. Are they getting paid for the risk? It depends on what CFOs are doing with the funds they are raising. We show most European corporates are still deleveraging and optimising costs to improve earnings. They remain very cautious on debt and ratings and continue to hoard cash, especially in the periphery. So while investors are getting exuberant, issuers are still behaving rationally. We remain long credit overall, but selectively underweight bonds of core firms that have strong incentives to add leverage.

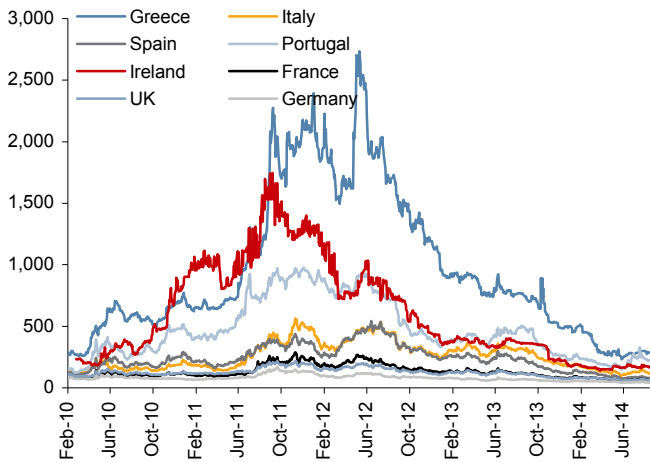
[Credit spreads: Towards the bottom in 2014](#) – 5 March 2014. The Ukraine-Russia crisis barely moved European spreads. Indeed, European economies now appear resilient to external shocks, as macro data continues to improve and capital comes back from riskier countries. But are investors still getting paid for the risks? Long Europe has become a crowded trade now, yet we still see positive catalysts on the horizon: ECB policy, corporate and bank fundamentals, sovereign reforms and technicals all remain credit positive. With few near-term risks, we think credit spreads will move from pricing based on volatility and tail risks to a new regime compensating primarily for default risk.

[Austrian banks: A dangerous waltz with emerging markets](#) – 21 February 2014. Emerging markets are the third leg of the credit crunch. Many have grown accumulating private leverage over the past decade, thanks to capital inflows. But these inflows are now reversing, and some EM central banks are raising rates to stop them. With higher rates, though, come higher funding costs and rising bad loans. Some European banks exposed to EM are already getting hurt. Austria's nationalised Hypo Alpe Adria is nearing resolution, as the government explores potential bail-in options. But the other Austrian banks, Erste, RBI and Bank Austria (a subsidiary of UniCredit), are also at risk of losses. We recommend selling Erste, RBI and UniCredit.

Credit Markets Watch

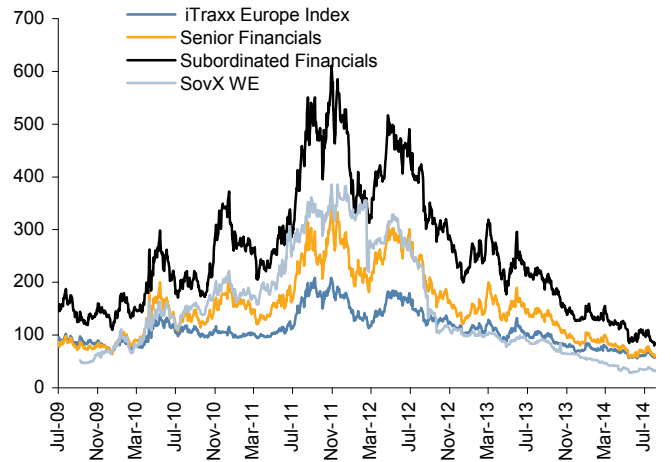
Spreads, sovereign risk, primary and secondary markets

Country average corporate credit spreads, bp



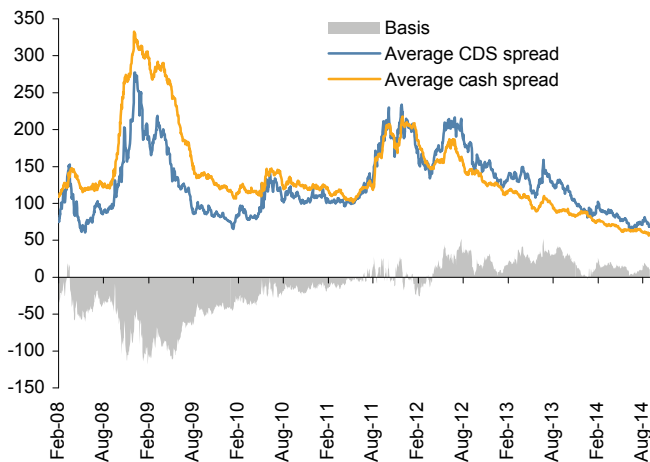
Source: RBS Credit Strategy, Bloomberg

iTraxx index spreads, 5-year on-the-run, bp



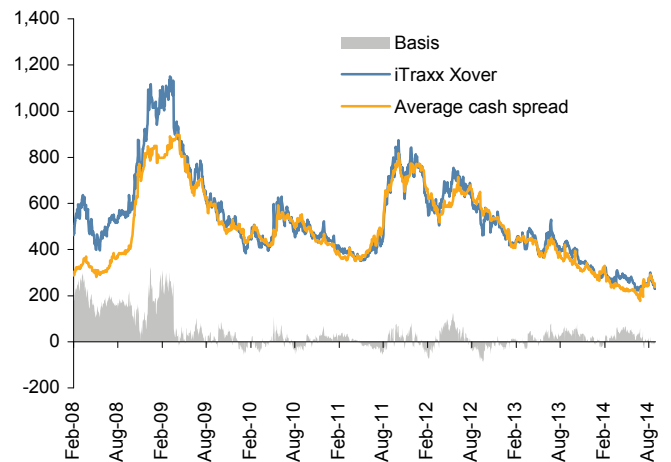
Source: RBS Credit Strategy, Bloomberg

iTraxx Main cash and CDS spreads and basis, bp



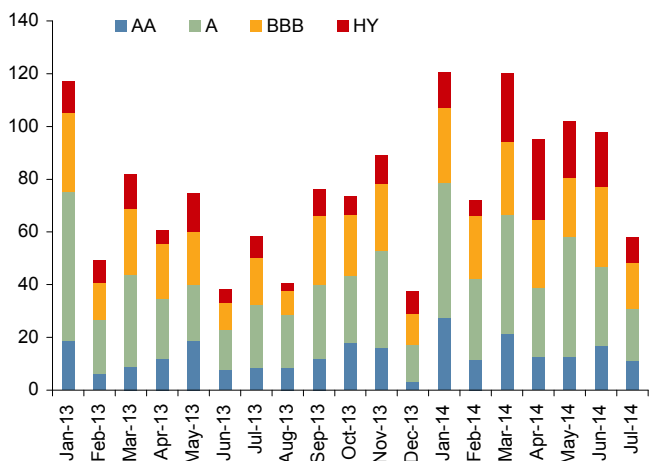
Source: RBS Credit Strategy, Bloomberg

iTraxx Xover cash and CDS spreads and basis, bp



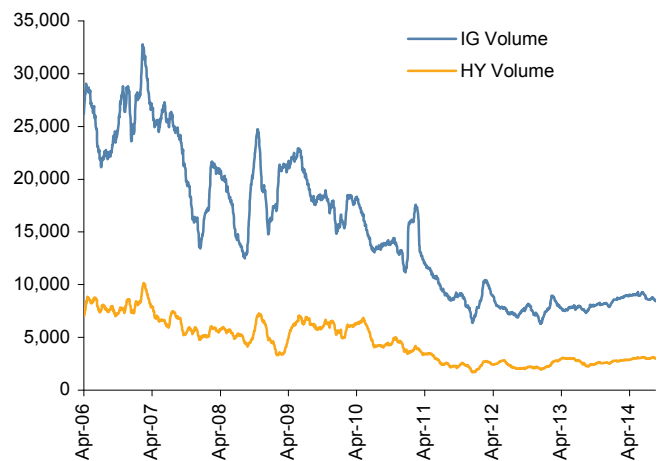
Source: RBS Credit Strategy, Bloomberg

Investment grade and high yield issuance, €bn



Source: RBS Credit Strategy, Bloomberg

TRACE 2-month trailing average daily trading volumes, \$m

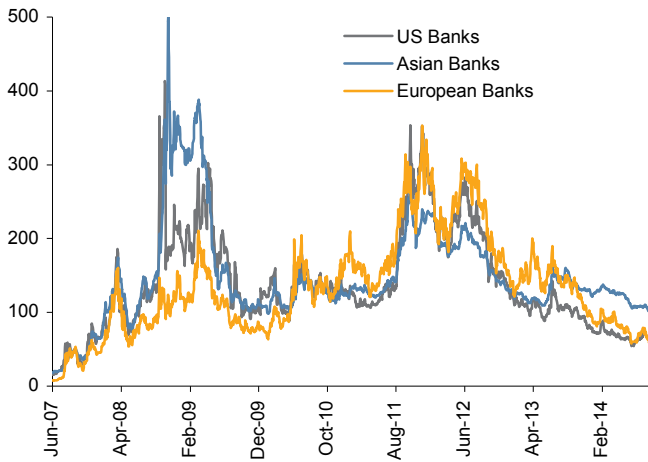


Source: RBS Credit Strategy, Bloomberg

Financial Stress Watch

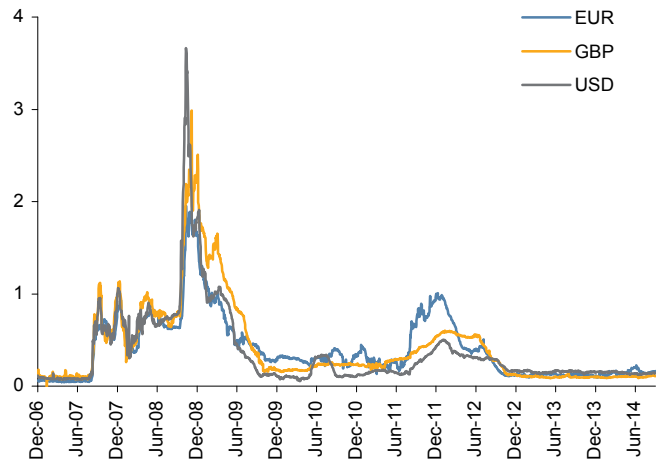
Bank spreads and risk in the financial system

Average bank spreads by region, bps



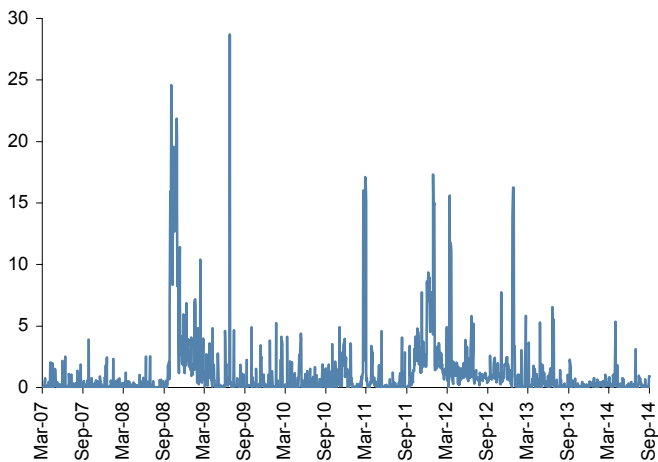
Source: RBS Credit Strategy, Bloomberg

Libor-OIS spreads, %



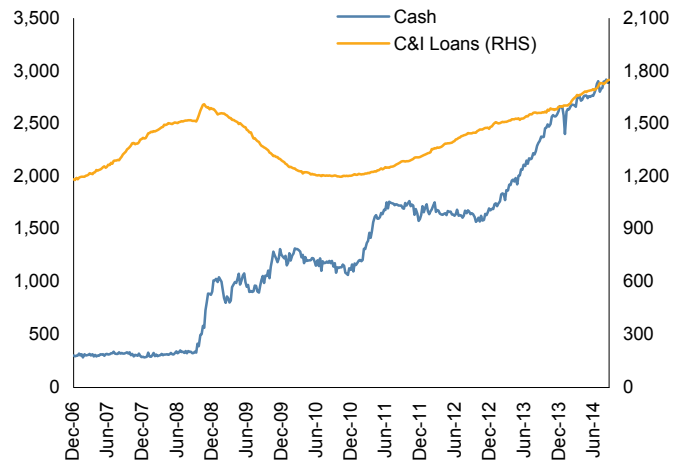
Source: RBS Credit Strategy, Bloomberg

Use of the ECB marginal lending facility, €bn



Source: RBS Credit Strategy, Bloomberg

Cash and C&I loans on banks balance sheets, \$bn



Source: RBS Credit Strategy, Bloomberg

US primary dealer corporate bond inventories, \$bn



Source: RBS Credit Strategy, Markit

US commercial paper outstanding from foreign issuers, \$bn



Source: RBS Credit Strategy, Bloomberg

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