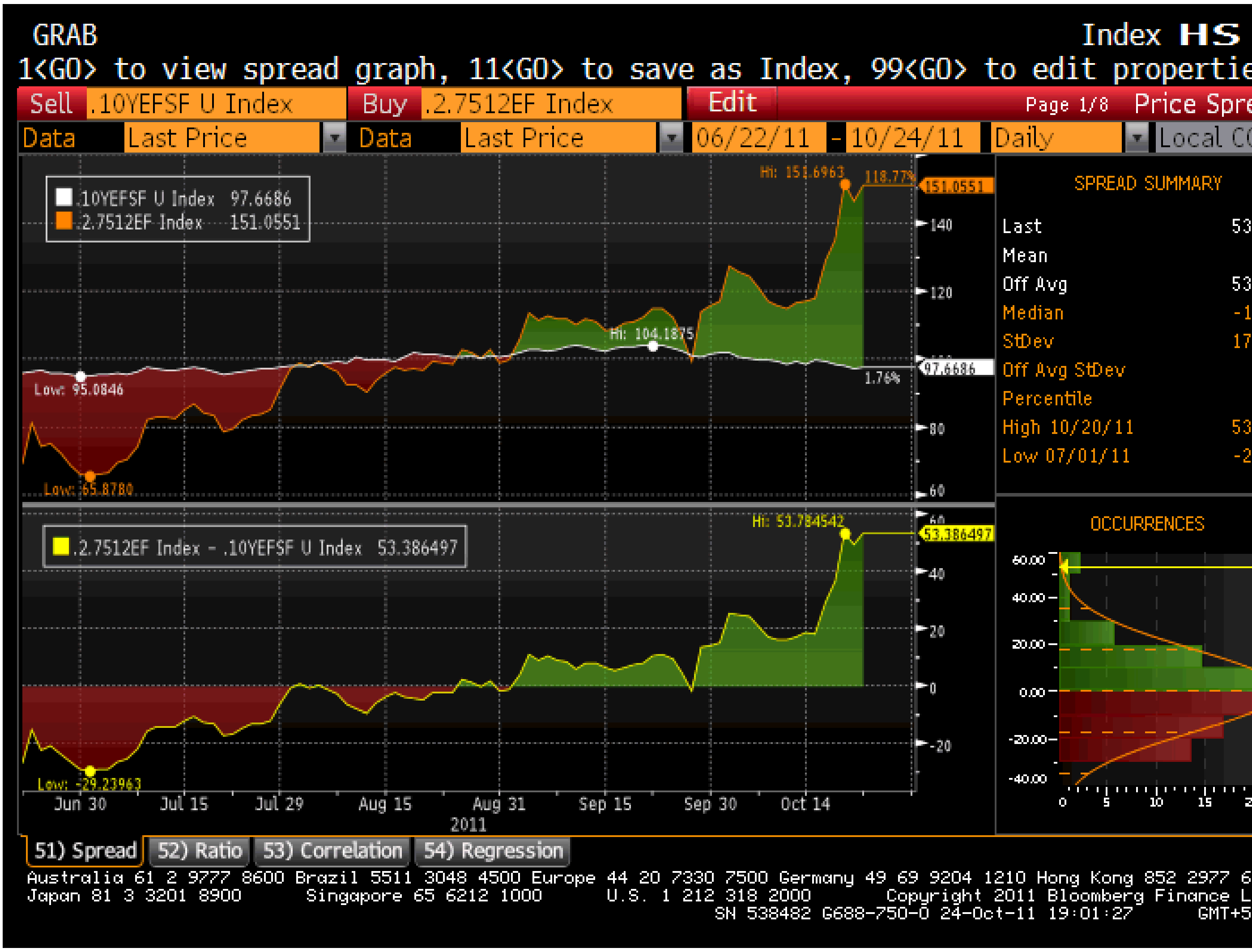
AXIS BANK

CREDIT SPREAD CURVE INVERSION OF EFSF BONDS

Inversion(higher short term rates as compared to long term rates) for EFSF bond spreads issued by the EFSF SPV has been noticed as of late and why this should be of any concern can be discerned by examining the 5y-10yr steepness of the CDS curve Financial Institutions and Banks from around the world. Why should we get into examining the arcane term structure of CDS curve for the EFSF? Because this instrument is being thought about as a vehicle that will ease the distress in either the role of a monoline or an insurance provider against losses on sovereign bonds and it will serve us well to examine what markets imply about the creditworthiness of such a vehicle which purports to leverage itself by either issuing bonds in the open market or by issuing ab-initio non funded guarantees to absorb the first 20% loss on sovereign bonds.

Chart: Inversion of EFSF CDS spreads



.2.7512EF Index refers to the 5yr EFSF Bond yield spread with respect to 5yr german bund yield
.10YEFSF Index refers to the 10yr EFSF Bond yield spread with respect to 10yr german bund yield

Credit Agricole 5yr CDS - 10 yr CDS

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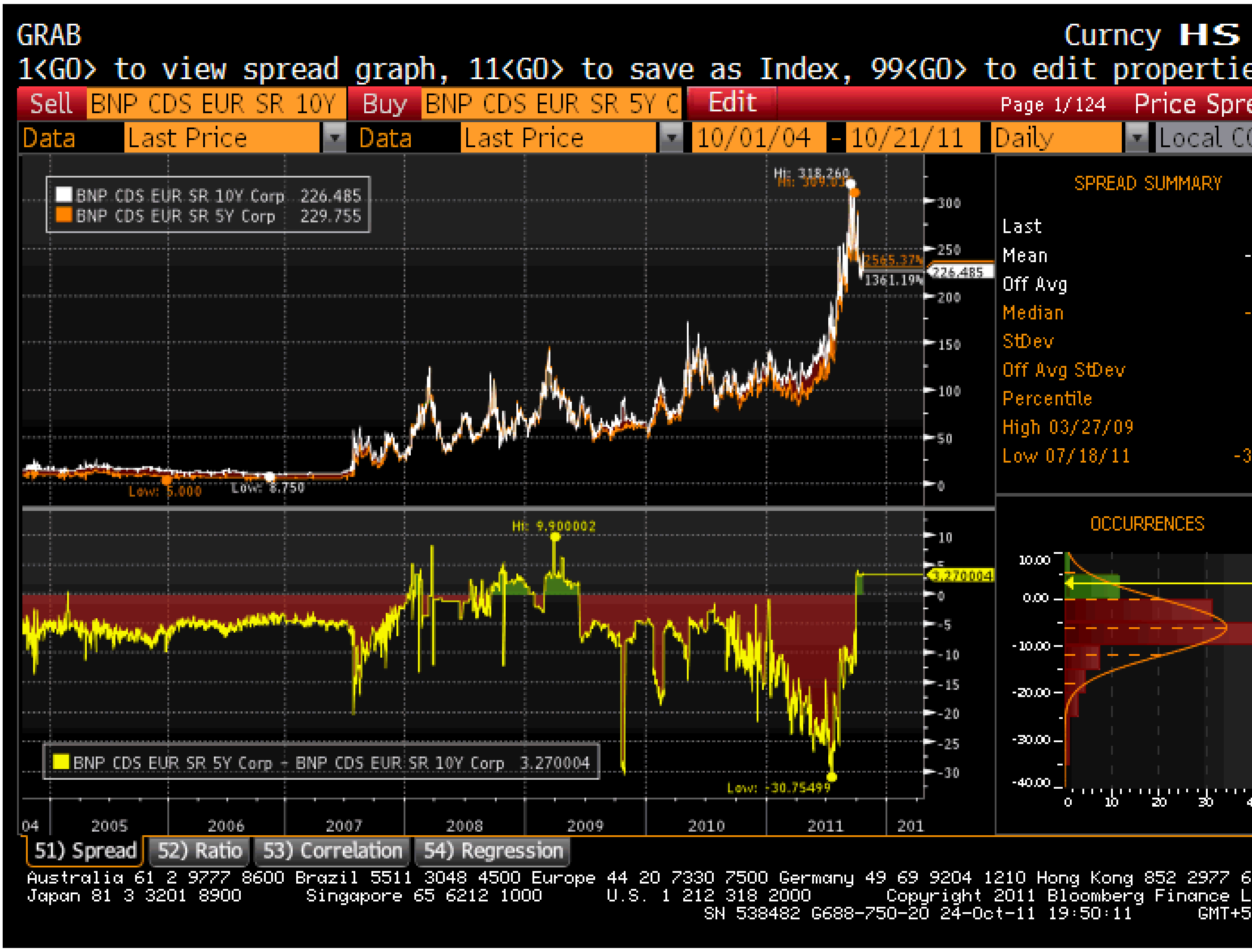
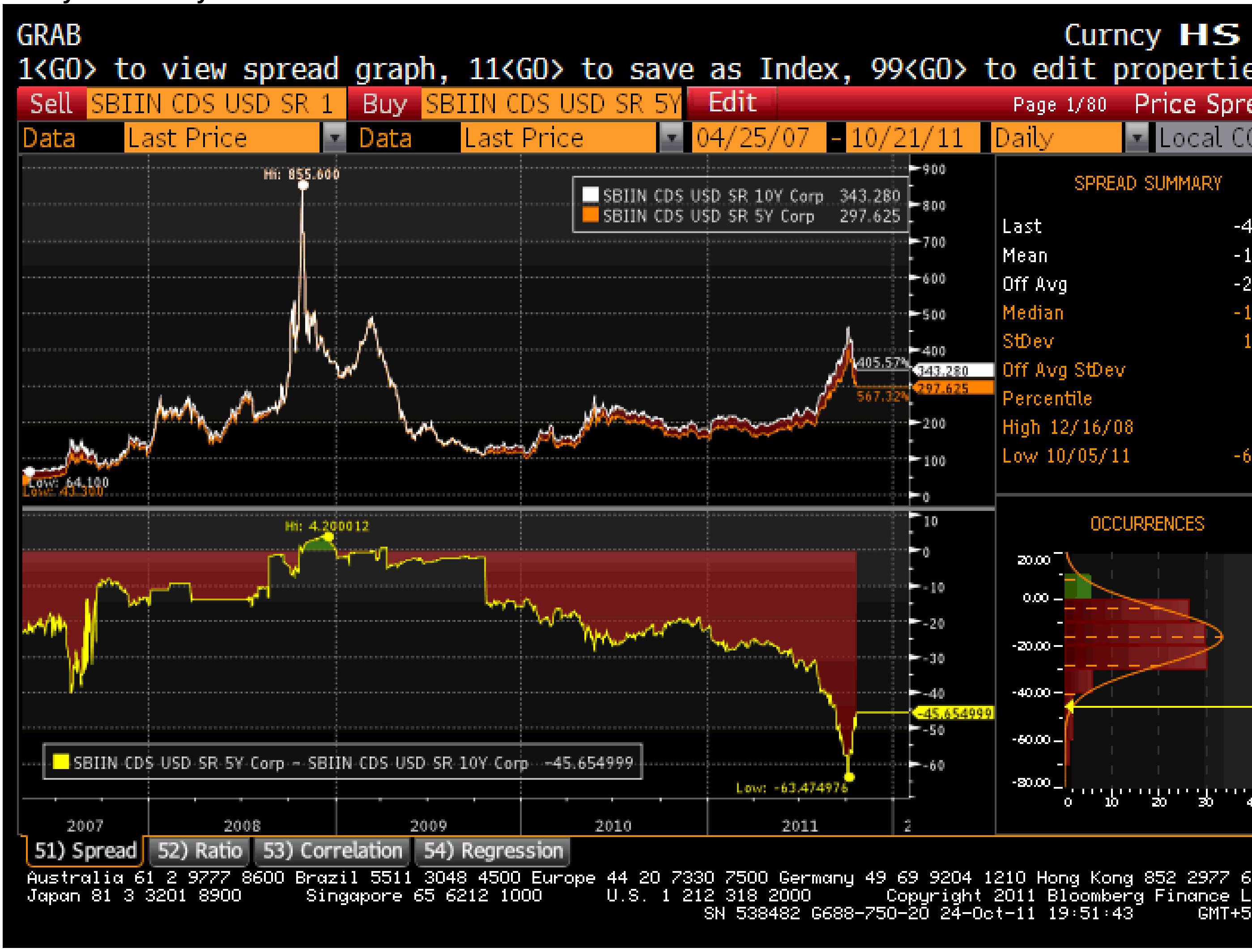
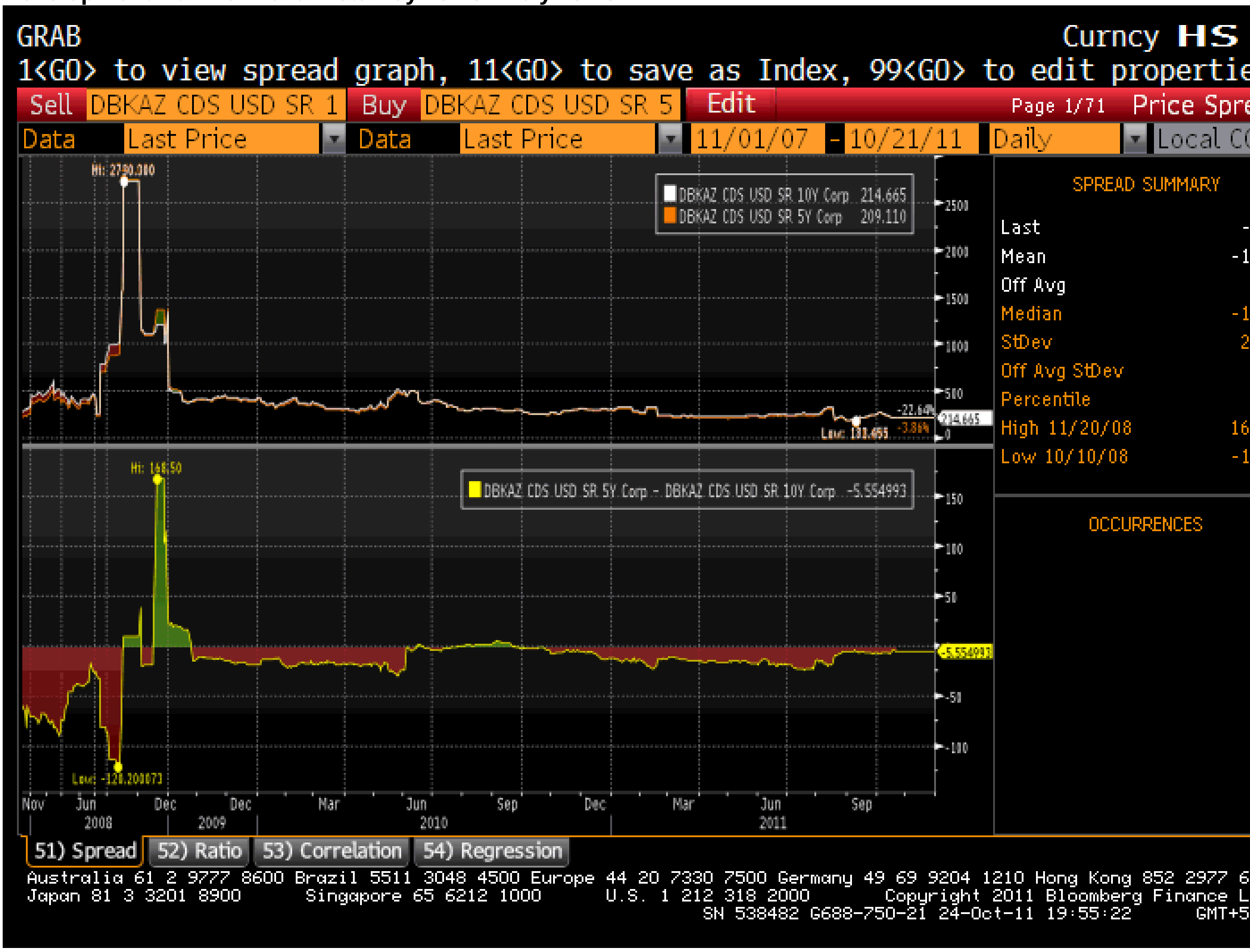
BNP 5yr CDS - 10 yr CDS



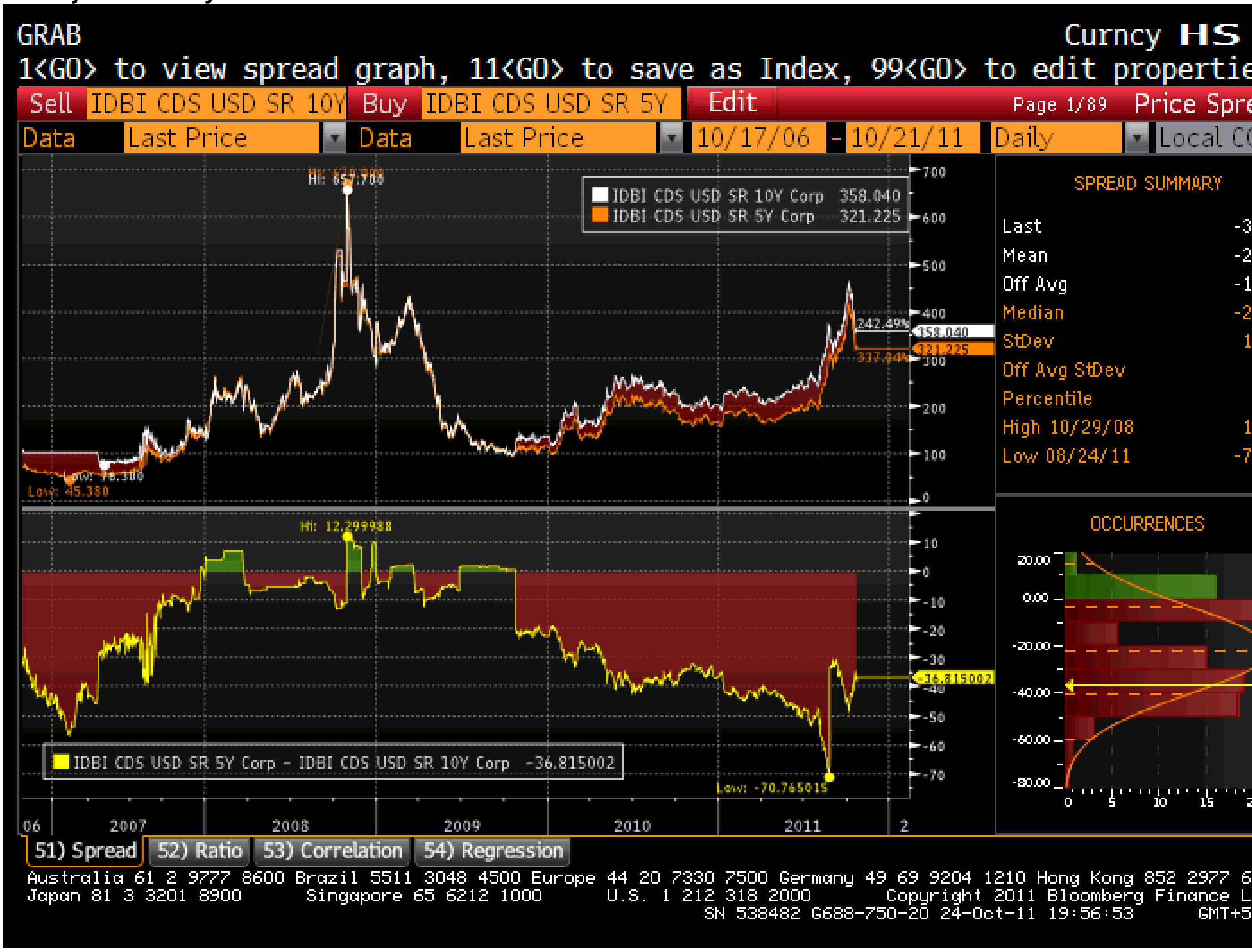
SBI 5yr CDS - 10 yr CDS



Development Bank of Kazakhstan 5yr CDS - 10 yr CDS



IDBI 5yr CDS - 10 yr CDS



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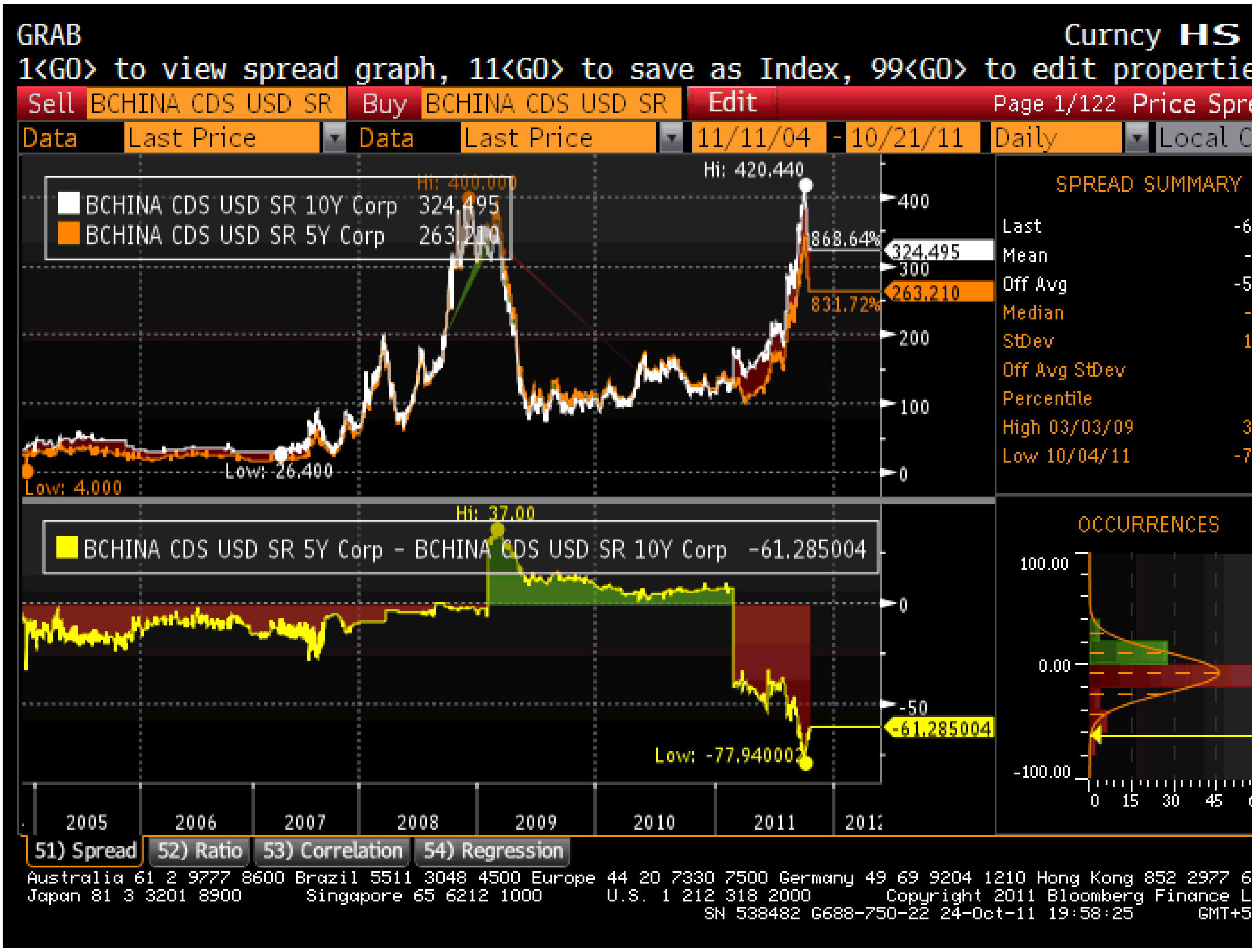
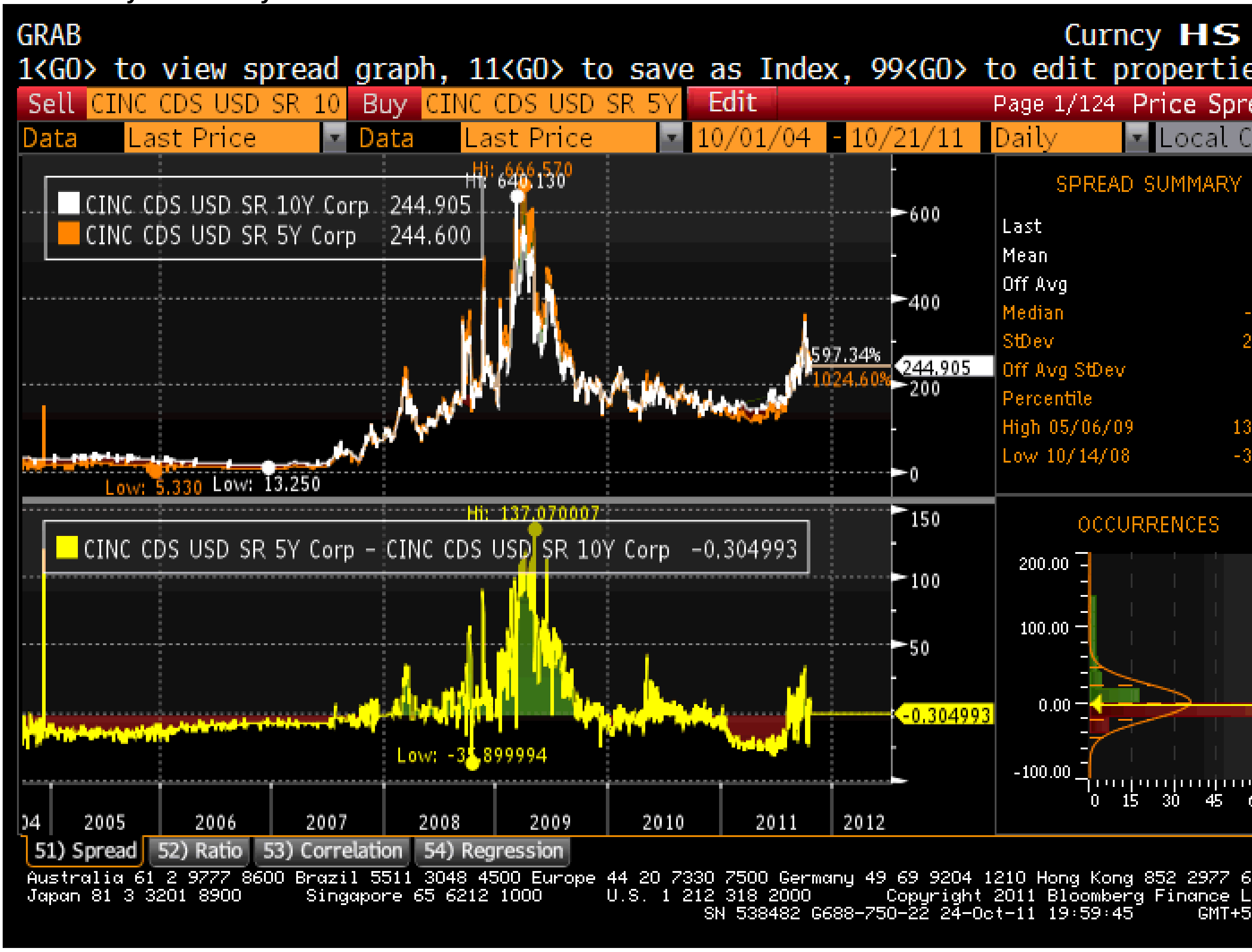
Bank of China 5yr CDS - 10 yr CDS



Citi Bank 5yr CDS - 10 yr CDS



Fanie Mae 5Y CDS -10Y CDS. Data upto September 2008 when it was nationalized by the US Treasury

If one carefully observes the above charts which examine many Banks and FI's across the world , one notices that the CDS curve inverts on very special occasions- financial distress, contagion or fear of contagion. The EFSF bonds that are trading in the secondary markets are already signalling that even without significant leverage as of today , the borrowing cost of the EFSF would rise significantly. With the ECB against itself funding the EFSF and insisting that it issue bonds in the market, the inversion of credit spread is a sign for concern. Without unlimited backstop to sovereign debt, a limitedly funded backstop like the EFSF will be unable to stabilize the market.

Again, the basic premise of the US interventions in 2008-09 to somehow let zombie banks function in the hope that someday somehow things will better with time is coming unstuck as the US Banks refuse to lend. This is exactly a re-run of the Japanese experience when in contravention to much Western preaching Japan saved it's Banks and the rest is, as they say, history. The ECB is now starting to emulate these two worthies and is taking utmost pains to repeat the same follies by trying to save it's supposed "banking "jewels".

What is required is a controlled failure of banks that have overextended themselves and consequent segregation of bad assets of the banks within the EU into a "bad bank"- all done with the unlimited backing of the ECB to protect the depositors. The "bad bank " - "good bank" model has worked in the past for countries like Sweden, China and Ireland that had suffered from Banking crises and is the only proven model to tackle such problems - all other solutions are fraught with negative outcomes: supporting zombie banks after the Japanese and the US model has clearly not worked.

Strategy

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