

Questions and Answers About S&P's European Downgrades

Because the recent European Union (EU) ratings cuts by Standard & Poor's were generally anticipated by investors, and were in most cases not as large as feared, the market reaction was relatively muted: some 10-year bonds rallied (Italy -22 basis points, Spain -7bps) while others sold off marginally (France +6 bps, Austria +6 bps, European Financial Stability Fund (EFSF) +10 bps) according to Bloomberg as of January 19. The notable exception was Portugal (10-year +200bps and 5-year +300bps) which is now rated below investment grade by all three agencies. Despite the tepid market response to the news, many investors are concerned about the potential impact of the downgrades on the eurozone crisis -- in particular, the implications for ratings on European banks and government guaranteed securities and for the composition of global indexes with exposure to downgraded sovereigns. Here, members of PIMCO's global product management team answer some of the most common questions being asked by investors:



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Q: Is this the end of the downgrades?

A: We do not believe this is the end of the downgrades for eurozone sovereigns or European banks because most remain on negative watch by the agencies. And yet the real concern about S&P's downgrades and further cuts by other agencies is the growing dispersion of ratings across the eurozone. Dispersion of ratings -- a reflection of the economic and financial bifurcation in the union -- is extremely problematic for the zone with a homogenized monetary policy yet heterogeneous fiscal positions. Moreover, by formalizing the credit differentiation within the eurozone, S&P's move could accelerate the trend of intra-euro capital flight, where investors show a greater home bias propensity when faced with eurozone policy and credit quality uncertainty.

Q: Will European banks be downgraded?

A: Sovereign downgrades will likely be another trigger for cuts in the ratings of European banks. Nearly all major eurozone banks are on negative watch. We believe the big Italian banks and Spanish banks are likely to see at least a one-notch cut with most major French banks also getting a one-notch downgrade. Concerns about market access are less relevant in an environment where most banks are already reliant on the ECB for their financing, but it should be noted that these downgrades may prolong banks' dependence on the central bank and delay their return to market funding.

	S&P: Reviewed 15 EMU countries mid-January		Fitch: Review 6 EMU credits below by end of Jan		Moody's: Revisit EMU rating level and dispersion 1Q12	
	S&P	Outlook	Fitch	Outlook	Moody's	Outlook
Norway	AAA	Stable	AAA	Stable	AAA	Stable
Sweden	AAA	Stable	AAA	Stable	AAA	Stable
Denmark	AAA	Stable	AAA	Stable	AAA	Stable
Germany	AAA	Stable	AAA	Stable	AAA	Stable
UK	AAA	Stable	AAA	Stable	AAA	Stable
Finland	AAA	Neg	AAA	Stable	AAA	Stable
Netherlands	AAA	Neg	AAA	Stable	AAA	Stable
Luxembourg	AAA	Neg	AAA	Stable	AAA	Stable
Austria	AA+	Neg	AAA	Stable	AAA	Stable
France	AA+	Neg	AAA	Neg	AAA	Stable
Belgium	AA	Neg	AA+	Review	Aa3	Neg
Spain	A	Neg	AA-	Review	A1	Neg
Italy	BBB+	Neg	A+	Review	A2	Neg
Ireland	BBB+	Neg	BBB+	Review	Ba1	Neg
Portugal	BB	Neg	BB+	Neg	Ba2	Neg
Greece	CC	Neg	CCC		Ca	Developing
Cyprus	BB+	Neg	BBB	Review	Baa3	Review
Estonia	AA-	Neg	A+	Stable	A1	Stable
Malta	A-	Neg	A+	Stable	A2	Neg
Slovenia	A+	Neg	AA-	Review	A1	Neg
Slovakia	A	Stable	A+	Stable	A1	Stable

Source: S&P, Fitch, Moody's as of 19 January 2012

Q: Will banks be less inclined to hold certain eurozone sovereign debt because of the downgrades?

A: Most eurozone government bonds owned by the eurozone banks carry a 0% risk weight as defined by prevailing regulatory capital rules. In theory, Italy's downgrade to BBB+ by Standard & Poor's should, therefore, have no impact on banks' ability to hold BTPs (Italian government debt, or Buoni del Tesoro Poliannuali). Despite theory, in practice these downgrades will likely put further pressure on foreign banks to reduce peripheral risk. But this de-risking is not new -- shedding of peripheral assets by banks has been a consistent feature of the past several months as banks have sought to shore up their capital ratios in line with European Banking Authority (EBA) stress tests and in an effort to demonstrate a reduction in peripheral risk exposures to international shareholders and creditors.

Q: How will government guaranteed securities fare in light of the downgrades?

A: All so-called "government guaranteed securities" of those countries that were downgraded are now at risk of a ratings cut, including EFSF bonds, which were

subsequently downgraded. Even those securities guaranteed by eurozone sovereigns not downgraded are also in the agencies' crosshairs. More recently, 25 government-related entities of Austria, Belgium, France, Germany, Italy, Ireland, the Netherlands and Spain were downgraded and many more were placed on negative watch.

Q: How does the EFSF downgrade impact its role in resolving the eurozone crisis?

A: With the rating of the EFSF dependent on the sovereign ratings that guarantee the fund, the subsequent downgrade of the EFSF was not surprising. At present, the EFSF has committed to fund a portion of the Portuguese and Irish bailouts, which should be manageable for it even with S&P's AA+ rating.

The credit quality of the EFSF is inherently linked to that of its underlying guarantors'. Further eurozone sovereign downgrades or higher yields would therefore drive EFSF borrowing costs higher. However, the real challenge for the EFSF isn't just its borrowing costs, but rather its ability to find buyers for its issuance fast enough in a crisis situation. If another country (aside from Ireland, Portugal and Greece) requires immediate support and the EFSF

cannot raise sufficient funds in a timely fashion, then the ECB is the only institution that can provide this emergency liquidity. So while the EFSF is part of the eurozone resolution, the EFSF is not a silver bullet. It's clear that the EFSF (in its current form) will not play the lead role in a eurozone resolution, but that was baked in before the downgrades.

Q: How will the downgrades impact the composition of global indexes?

A: Each index provider utilizes a different methodology for calculating the ratings in their index based on the agency ratings — e.g., higher of (or average of) methodologies. In the recent S&P eurozone downgrades, the most relevant for benchmark compositions was Portugal -- downgraded to below investment grade by S&P, now consistent with Moody's and Fitch. Portugal will be removed from the Citi suite of indexes at the end of January, affecting the February profile. The following table represents the decrease in a market capitalization of some of Citi's flagship indexes as result of Portugal's downgrade and

removal. It should be noted, however, that subsets of these indexes could have a much larger impact.

Index	Change
World Government Bond Index	-0.40%
EMU Government Bond Index	-1.47%
World Broad Investment Grade Index	-0.24%
Euro Broad Investment Grade Index	-0.84%

Source: Citi as of 19 January 2012

The downgrades will not result in any countries being removed from Barclays indexes. The table below from Barclays captures the changes, and its new index ratings. Again, subsets of the major indexes could have an impact. For example, note that Spain is now rated single-A, and would be removed from a AAA-AA only index.

JP Morgan has confirmed that no countries will be removed from its indexes.

	Moody's	Fitch	S&P (Prior)	S&P (Updated)	Index Rating (Prior)	Index Rating (Updated)
Austria	AAA	AAA	AAA	AA+	AAA	AAA
Cyprus	BAA3	BBB	BBB	BB+	BAA2	BAA2
France	AAA	AAA	AAA	AA+	AAA	AAA
Italy	A2	A+	AAA	BBB+	A2	A2
Malta	A3	A+	AAA	A-	A2	A2
Portugal	BA2	BB+	BBB-	BB	BA1	BA2
Slovakia	A1	A+	A+	A	A1	A1
Slovenia	A1	AA-	AA-	A+	AA3	A1
Spain	A1	AA-	AA-	A	AA3	A1

Source: Barclays as of 19 January 2012

Note: Index Rating refers to countries within the Barclays indexes.

Biographies

Mr. Fisher is an executive vice president and product manager in the Newport Beach office, responsible for traditional global fixed income and currency products as well as the Global Advantage Strategy. Prior to joining PIMCO in 2008, he was a managing director and head of global fixed income at Halbis, the asset management arm of HSBC. He previously worked as a global bond portfolio manager at Credit Suisse Asset Management and Fischer Francis Trees & Watts. He has 19 years of investment experience and holds an undergraduate degree in Asian history from Princeton.

Mr. Story is a vice president and product manager in the London office, responsible for European and global products. Prior to joining PIMCO in 2011, he was a product specialist at Western Asset Management Company, where he covered global macroeconomic strategies. He previously worked at the Federal Reserve Bank of San Francisco. He has 12 years of investment experience and holds a master's degree in economics from the London School of Economics. He received an undergraduate degree from the University of San Diego.

Ms. Albrecht is a product manager on the global team in the Newport Beach office. Prior to joining PIMCO in 2011, she worked at Cerberus Capital Management in Frankfurt, Germany, focusing on aerospace and defense transactions. Previously she was a manager in corporate international business development at Lockheed Martin; she has also held positions at Mubadala Development Corporation in Abu Dhabi, UAE, and at the U.S. Department of Defense in Virginia. She has three years of investment experience and holds an MBA from Columbia Business School, along with a master's degree from Columbia University's School of International and Public Affairs and an undergraduate degree from Princeton University.

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