EU Bank Stress Tests - No Heavy Lifting Required / July 2010

CONNING REVIEW AND ANALYSIS

Background

Much of the turmoil in European financial markets during the first half of 2010 was caused by fears about sovereign stress (and even default) in the peripheral countries (namely Portugal, Ireland, Italy, Greece & Spain). Following the announcement of an EU-led bail-out package for Greece in May 2010, attention focused on the other periphery countries. Here the concern was not so much on the actual sovereign debt levels themselves, but rather the sovereign's ability to provide support to their banking systems, much of which was perceived to be under-capitalized. This, in turn, was affecting the ability of individual banks to access funding via the normal route of the interbank market and forcing them to increasingly rely on direct funding from the ECB. Even the announcement of the mammoth €750 billion European Financial Stabilization Facility (EFSF) failed to bring any relief to financial markets and concerns quickly began to rise, especially about the health of the Spanish banking system.

In an attempt to address these concerns, the Committee of European Banking Supervisors (CEBS) was mandated by the Economic and Financial Affairs Council (ECOFIN for short and composed of the Economics and Finance Ministers of the EU member states) to conduct an EU-wide bank stress testing exercise. Market participants quickly began to anticipate that this exercise would be a panacea for the European banking system as long as three basic criteria were addressed in the report:

(1) The report and results had to be transparent. Investors wanted to see individual bank data, not an aggregation of country data.

(2) The tests had to use consistent data. It would be no use using different criteria for different countries or banks; in other words, if GDP were assumed to fall 3%, it should fall 3% in each country.

(3) The test criteria should be realistic. There would, for example, be little use in aiming for a Tier 1 capital ratio of 4% if the market is expecting at least 6%.

Stress Test Scenarios

The stress tests focused predominantly on credit and market risks, including the exposures to European sovereign debt. An important point to note is that the tests were meant to stress capital adequacy and not liquidity. CEBS together with ECB and the EU Commission developed two stress test scenarios which were then applied to the individual banks over a period of 2010 and 2011:

(1) Benchmark Macro-Economic Scenario

(2) Adverse Macro-Economic Scenario

The **Benchmark scenario** was based on the EU Commission's Autumn 2009 and Interim 2010 forecasts with several adjustments reflecting the impact of recent sovereign crisis in Europe.

Assumptions were as follows:

- GDP growth 0.7% in 2010 and 1.5% in 2011 for EMU
- GDP growth 1% in 2010 and 1.7% in 2011 for EU
- GDP growth 2.2% in 2010 and 2% in 2011 for the US
- Unemployment 10.7% in 2010 and 10.9% in 2011 for EMU
- Unemployment 9.8% in 2010 and 9.7% in 2011 for EU
- Unemployment 10% in 2010 and 10.2% in 2011 for the US
- Equity exposures in trading book have been subject to a cumulative haircut of 19% over two years.
- 3% the average two-year cumulative loss for corporate exposures and 1.5% for retail exposures
- Evolution of commercial property prices ranged from -20% to 2% in 2010 and from -15% to 2.7% in 2011
- Evolution of residential property prices ranged from -13% to 2% in 2010 and from -5.2% to 2.7% in 2011

The **Adverse scenario** was based on ECB estimates and also includes so-called 'sovereign confidence shock' scenario. The impact of this on any EU country varies, depending on its respective situation in the sovereign debt crisis.

Assumptions:

- GDP growth 0% in 2010 and -0.4% in 2011 for EU
- GDP growth 1.5% in 2010 and 0.6% in 2011 for the US
- Unemployment 10.5% in 2010 and 11% in 2011 for EU
- Unemployment 10.2% in 2010 and 11.1% in 2011 for the US
- 4.4% average two-year cumulative loss for corporate exposures and 2.1% for retail exposures
- Equity exposures in trading book subjected to a cumulative haircut of 36% over two years.
- EU-specific shock to the yield curve, an upward shift in the yield curve of 125 bps for 3-month rates and 75 bps for 10-year rates by the end of 2011.
- Commercial property prices ranged from 35% falls to 2% rises in 2010 and from 30% falls to 2.7% rises in 2011, depending on the country.
- Residential property prices ranged from 17% falls to 2% rises in 2010 and from 15.2% falls to 2.7% rises in 2011, again dependent on the country.

So in reality, the **Benchmark Macro-Economic Scenario** assumes moderate recovery in Europe in the foreseeable future, while the **Adverse Macro-Economic Scenario** assumes Europe slipping back into recession.

In order to stress the holdings of sovereign debt by the various banks, a haircut was applied to each country's debt, depending on the macro-economic scenario envisaged. The table below illustrates the various hair-cuts, peaking with a 23% haircut on Greek sovereign debt. These haircuts were applied to current market prices.

VALUATION HAIRCUTS	Benchmark Scenario		Adverse Scenario	
	2010	2011	2010	2011
Slovenia	0.0%	1.1%	1.4%	4.2%
Germany	0.1%	2.5%	2.3%	4.7%
Slovakia	0.1%	2.4%	1.6%	5.0%
The Netherlands	1.1%	2.5%	3.0%	5.2%
Denmark	0.0%	1.4%	2.1%	5.2%
Austria	1.0%	2.8%	3.1%	5.6%
France	1.5%	3.0%	3.7%	6.0%
Finland	0.0%	3.3%	1.9%	6.1%
Malta	0.7%	3.6%	2.9%	6.4%
Cyprus	0.3%	3.2%	3.0%	6.7%
Sweden	1.3%	2.3%	5.0%	6.7%
Belgium	1.4%	3.1%	4.3%	6.9%
Luxembourg	1.4%	3.1%	4.3%	6.9%
Italy	1.2%	2.9%	4.9%	7.4%
UK	5.0%	6.9%	7.7%	10.2%
Czech Republic	0.0%	2.7%	4.6%	11.4%
Other EU countries	1.3%	4.4%	5.5%	11.8%
Spain	1.3%	4.1%	6.7%	12.0%
Poland	2.6%	6.1%	6.4%	12.3%
Ireland	1.6%	4.2%	8.6%	12.8%
Portugal	2.3%	3.7%	11.1%	14.1%
Greece	3.9%	4.3%	20.1%	23.1%

Results

Of the 91 banks tested, seven failed. Five were Spanish (Banca Civica, Caixa Catalunya, Caja Espana, Caixa Sabadell, CajaSur), one German (Hypo Real Estate) and one Greek (ATEbank). Banks were considered to have failed the stress test if they did not maintain a Tier 1 ratio of 6% under both scenarios. This equated to a pass rate of 92% and the total capital shortfall was €3.5 billion, well below consensus market estimates, though overall losses under the most stressed scenario were €566 billion. The high pass rate is attributable to the low capital hurdle rate and sovereign debt haircuts on trading book holdings only.

None of the banks that failed are systemically important and all have previously agreed government support mechanisms. The Spanish banks that failed are new or existing savings banks ("cajas") and will be covered by the Spanish government's support mechanism (FROB). Banks that failed the test are expected to draw up recapitalisation plans with their local regulator. The banks that failed have total risk weighted assets of €240 billion, comprising only 2% of European banking assets. However, there were a number of marginal passes – if the hurdle rate had been 7%, 24 banks would have failed the test.

The positive pass rate of European banks does come with caveats. The European banks tested only hold 21% of sovereign debt holdings as trading assets and, perhaps more controversially, the sovereign stress scenario did not incorporate any default. This is to be consistent with the stated EU policy of "no government default" and the test worked off market conditions of May 2010 when the Greek crisis peaked. Capital concerns also remain as the test included capital to be provided / obtained under restructuring plans agreed but not necessarily yet implemented. Also, 6% Tier 1 capital is well below most accepted standards; Core Tier 1 is a better barometer but lacks an EU-wide definition. Capital requirements are also complicated, with the uncertainty surrounding potential Basel III requirements (unlikely to be known before Q4'10). Finally, the test made no reference to liquidity, a situation more relevant for Greece during recent market turbulence.

The results of the European stress tests relative to the 2009 U.S. stress tests are informative. The U.S. stress tests were conducted in a weaker economic environment with slightly more severe assumptions (primarily the likelihood of the "adverse" scenario occurring, 215% for the U.S. vs. 5% for Europe). The U.S. stress tests saw a 53% pass rate (10 out of 19 passed) with Tier 1 ratios in line with current European levels. The U.S. stress tests resulted in recapitalisation requirements of $75bn vs. €3.5bn in Europe. However European banks have less reliance on preferred / hybrid capital, and were starting from a better-capitalised position with Core Tier 1 (U.S. equivalent - Tier 1 Common RWA) of 8.8% vs. 5.3% for the U.S. at the time of its stress tests. The U.S. banks stress-tested in 2009 now have an average Tier 1 ratio of 12.6% with a Tier 1 Common / RWA ratio of 9.2%. Capital comparisons are slightly complicated by the differing application of Basel risk weightings. It also should be noted that the U.S. banks were tested in the midst of a recession whilst the European tests took place against the backdrop of a growing global economy.

Market Reaction

Although it might be considered too early to gauge the long-term market reaction, we can say that the immediate reaction in European markets was slight scepticism, followed by a strong rally in CDS and cash prices. The bad news is that the stress test criteria probably weren't stressful enough – the good news is that investors got a lot more detail about banks' balance sheets than expected, thus allowing analysts to conduct their own stress tests using their own criteria.

CDS levels on most European banks were unchanged throughout Monday morning (July 26) but rallied strongly in the afternoon, with some significant tightening (20-25bps) in the peripheral banks. Those banks seen as winners (most notably the two big UK banks, RBS and Lloyds) saw a more significant tightening of 15-20bps in their CDS levels. German banks, who initially didn't disclose their individual country exposures, at the margin were slightly weaker by 2-5bps. The same pattern was repeated in equity markets with the riskier names gaining more than the safer banks. Sovereign spreads and CDS were generally tighter with peripheral countries tightening by 15-25bps and core European countries tightening by 4-8bps.

We will be carefully watching the interbank market because it is this area where the success (or not) of the stress tests will be apparent – if peripheral banks can reduce their direct ECB funding and replace it with interbank funding, the whole exercise will have been worthwhile.

Other market thoughts – European bank stress tests have played only a part in the rally this month; the rally can be explained by a combination of factors, not by just one. Many of the concerns that sent the markets lower in May and June have been addressed (at least partially) or the uncertainty lessened:

1) Goldman Sach's $550mm settlement of fraud charges with the SEC
2) Passage of the U.S. Dodd-Frank Law
3) Earnings season – although there are occasional revenue misses, earnings have largely beaten expectations (particularly the industrial sector), with many companies lifting their outlooks for the balance of 2010 and 2011 (surprising the market)
4) BP – successful implementation of the containment cap with completion of the relief wells on target

And, just this morning, Moody's Investors Service said the results of the stress tests on 91 European banking groups by the Committee of European Banking Supervisors will not affect European bank ratings.

Conclusions

It's hard to deny the markets' general reaction to the results which has been somewhat underwhelming – a feeling that the stress criteria weren't that stressful but probably as stressful as any official agency is going to test. The key point is that investors now have the tools to conduct their own stress tests using their own criteria, which in turn will highlight to investors which banks remain at risk. We list below our major take-aways:

- "Adverse" economic scenario was not truly stressful. For example, it uses an 11.5% unemployment rate which is only 1.5% higher than the Q1 2010 realised rate.
- Exclusion of banking book sovereign exposures was disappointing, although to be expected. The EU has told investors that the European Financial Stabilisation Facility means no sovereign will default, ergo, no need to test the banking book for exposures.
- Likewise the lack of any sovereign default / restructuring in the test is also disappointing and not really stressful, although it's to be expected for the reason noted in the point above.
- Probably most importantly, the hurdle level of 6% for Tier 1 capital is too low for investors' comfort. Most investors now consider a Tier 1 capital level of 8% to be the minimum required. This implies that those banks that tested for capital levels between 6% and 8% will either have to raise capital or still be treated with caution by investors.
- The results confirm our view that the "national champion" banks are healthy but that the smaller banks / peripheral banks have more work to do (34 of the 40 least-capitalised banks are in the periphery region).

- On the positive side, investors now have much more clarity on the composition of banks' balance sheets, especially in Spain which was a major concern.

As noted above, the real success of the exercise will be judged on whether the peripheral / weaker banks can access non-ECB funding in the near future. We recommend that investors monitor Euribor / OIS spreads to see if they start to compress, which would signal a return of confidence. Also worth monitoring will be sovereign CDS measures and, in particular, peripheral CDS to see if they continue the tightening we have observed in the last two weeks. Lastly, bond yield spreads to Germany for the various countries will be a major indicator of confidence in a sovereign (or lack of it, whichever may be the case).

In summary, we suggest that investors ignore the headlines and focus on the transparency now available and which allows managers to make more-informed decisions about what banks are suitable investment candidates. ◆

Conning Asset Management (Europe) Limited