European Bank Stress Tests

Tough overall and Transparent

Table 1: Stress test s – Headline numbers

	Actual	Benchmark "mild recovery"		Adverse "double-dip"		Adverse "double-dip" + sovereign shock	
	2009	2010	2011	2010	2011	2010	2011
Losses, €bn							
Impairment	206	177	152	234	239	245	267
Trading				13	13		54.1
Total, 2010+2011			**329.0**		**498.9**		**566.1**
Loss vs. benchmark, €bn							
adverse scenario					**169.9**		**169.9**
sovereign shock							**67.2**
Total, 2010+2011					**169.9**		**237.1**
Tier 1							
Ratio	10.3%	10.7%	11.2%	10.0%	9.6%	9.9%	9.2%
Funds, €bn	1,162	1,213	1,277	1,166	1,163	1,159	1,118
No banks <6%							7
Shortfall, €bn							3.5
Risk weighted assets €bn	11,291	11,370	11,407	11,673	12,153	11,673	12,153
Pre-impairment income €bn	270	261	277	251	258		

Source: CEBS, SG Cross Asset Research/Economics

Table 2: Selected assumptions, benchmark and adverse scenario

	Actual	Benchmark		Adverse	
	2009	2010	2011	2010	2011
GDP growth, % yoy					
US	-2.4	2.2	2.0	1.5	0.6
EU 27	-4.2	1.0	1.7	-0.2	-0.6
Euro area	-4.1	0.7	1.5	-0.2	-0.6
Germany	-5.0	1.2	1.7	0.2	-0.6
France	-2.2	1.2	1.5	0.7	-0.1
Italy	-5.0	0.7	1.4	-0.3	-0.3
Greece	-2.0	-4.1	-2.6	-4.6	-4.3
Ireland	-7.1	-1.4	2.6	-2.1	1.0
Portugal	-2.7	0.5	0.2	-0.3	-2.3
Spain	-3.6	-0.6	1.0	-1.4	-1.2
Commercial property prices, yoy					
Germany		0.0	0.0	-10.0	-10.0
France		-4.5	-2.5	-4.5	-4.5
Italy		-0.7	0.3	-1.6	-2.0
Greece		-3.0	0.0	-5.0	-2.0
Ireland		-14.0	-6.0	-17.0	-8.0
Portugal		0.0	0.0	0.0	0.0
Spain		-20.0	-15.0	-35.0	-30.0
Residential property prices, yoy					
Germany		0.0	0.0	-10.0	-10.0
France		-4.5	-2.5	-4.5	-4.5
Italy		-0.7	0.3	-1.6	-2.0
Greece		-3.0	0.0	-5.0	-2.0
Ireland		-13.0	-2.5	-17.0	-5.0
Portugal		-5.0	-5.0	-5.0	-5.0
Spain		-3.8	-5.2	-8.8	-15.2
	2009		**2010/11**		**2010/11**
Loss rates on different exposures					
Corporate	1.5		3.0		4.4
Retail	0.8		1.5		2.1
Haircuts					
Equity, %			19		36

Source: CEBS, ECB, EU Commission, SG Cross Asset Research/Economics

The European Bank stress tests released Friday evening delivered on both toughness and transparency. The more surprising element was that the capital shortfall of the 7 failed banks "only" amounted to €3.5bn. The one disappointment was that the sovereign stress test was only applied to the banks' trading books. Counterbalancing this, however, the adverse scenario was tougher-than-expected on commercial, consumer and real estate loan losses.

While we find the stress tests to be good news on balance, several headwinds loom. First, European banks still have €197bn of government support. Second, there is still substantial uncertainty surrounding the types of capital needs that will result from Basel 3. Finally, the challenge of taming public finances still lies ahead.

Against the backdrop of a still frail economic environment, we still see a bumpy road ahead. Ultimately, the key variable for both banks and sovereigns is market funding conditions. If these deteriorate, the ECB would be ready – if necessary - to offer more liquidity to banks. Moreover, the ECB could also increase the SMP. Finally, the EFSF is now operational and could offer support to weaker euro area member states (and we would not be surprised to see some of the weaker sovereigns apply for assistance).

Picking up on the six questions we raised in our Economic News on July 22, we conclude that the test we overall tough and transparent. While the focus of the stress tests was capital, the real issue day-to-day is funding. Here the actions of central banks remain key.

1. Tough enough? Yes.

A "mild recovery" - broadly in line with our own central scenario - severed as the benchmark for the stress tests. In the adverse scenario, a shock equivalent to a "double dip" was applied (cf. table 2), and was differentiated by country. Compared to our prior expectations, the economic shock was moderately tougher.

michala.marcussen@sgcib.com

klaus.baader@sgcib.com

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Turning to the interest rate shock, the CEBS prior to the tests referred to the episode in early May as a reference. As seen from the table below, the final shock applied was more severe and also included a shock of 125bp to short term interest rates to take account of deterioration in interbank liquidity conditions under a sovereign risk shock.

Main point of criticism: The sovereign risk shock assumed no sovereign default. The criteria, moreover, did not account for future changes under Basel 3. Note, the tests did account for CRD II and III (Capital Requirements Directive). Moreover, Basel 3 will not be known before the end of the year and actual implementation is likely to fall beyond the period covered under the stress tests.

Table 3: A tough interest rate shock

5-year government bond yields

	Stress test				Early May episode		
	End-09	Bench-mark 2011	Adverse 2011	Country specific shock in bp	Change 3 May to 7 May	Spot 3 May	Spot 7 May
Austria	2.69	3.00	4.04	29	-23	2.43	2.21
Belgium	2.79	3.23	4.47	49	1	2.67	2.68
Finland	2.62	3.16	4.16	25	-32	2.22	1.90
France	2.48	2.94	3.92	24	-31	2.14	1.83
Germany	2.42	2.74	3.49	0	-37	2.02	1.65
Greece	4.96	6.28	13.87	685	422	10.37	14.59
Ireland	2.91	3.28	5.62	158	108	3.71	4.79
Italy	2.80	3.19	4.80	86	48	2.77	3.25
Netherlands	2.46	2.87	3.82	20	-27	2.01	1.74
Portugal	3.08	3.96	7.40	268	137	4.70	6.08
Spain	2.96	3.61	5.78	142	40	4.04	4.44
UK	2.81	4.02	5.07	30	-7	2.65	2.57

Source: ECB, CEBS, Bloomberg, SG Cross Asset Research/Economics
Note: the benchmark for Ireland in the early May episode is a 4-year

2. Transparent and consistent enough? Yes.

Overall, we find the tests to be both consistent and transparent. CEBS offered a 55 page summary report and with that details of the results on a bank-by-bank basis.

Main point of criticism: Greater detail on the sovereign portfolios on a bank-by-bank basis would have been appreciated by the markets.

3. How severe will the loss be under the adverse scenario and sovereign shock? €237bn more than in the benchmark scenario

The stress tests found an estimated €566bn of losses over 2010 and 2011 under the adverse economic scenario and the sovereign risk stress. This translates into €237bn more than in the benchmark scenario and compared to our own prior estimate of €110bn - 225bn. Breaking down the losses (cf. table 1), we find that the additional losses in the adverse scenario compared to the benchmark scenario amount to €169.9bn. This is above our own prior estimate of €75bn to €150bn. Adding the sovereign stress, the additional loss amount to €67.2bn, within the range of our own estimate of €35bn to €75bn. Our estimate accounted for a much milder shock – using the early May episode as the reference and with a symmetrical interest rate shock of between 0 and 40bp. Moreover, we only accounted for the interest rate shock on government loans and securities. The stress tests, on the other hand, applied a broader symmetrical interest rate shock, but only accounted for haircuts to sovereign paper in the trading book.

Main point of criticism: The sovereign risk shock only applied valuation hair-cuts to the trading book and not the banking book. Note, however, that additional impairment losses on the non-sovereign exposures resulting from the interest rate shock were accounted for.

4. How much additional capital will be needed? €3.5bn

The stress tests showed 7 banks (5 in Spain, 1 in Germany, 1 in Greece) failed the criteria of a Tier 1 capital ratio above 6%. In total, this generates new capital needs of €3.5bn, well below that €30bn we had expected to see.

Main point of criticism: The stress tests did not explicitly consider the continued reliance on government support. In total, 38 banks out of the 91 banks in the sample benefit from support. This amounts to €197bn, or 1.2 percentage points measured in terms of Tier 1 capital.

5. Is there a credible plan to raise capital? Yes.

Raising the capital required should not prove an issue. Moreover, bank recapitalisation schemes have ample room (Germany's SoFFin has around €50bn available for recapitalisation, Spain's FROB €87bn and Greece's FSF €50bn).

6. What is the macro impact? Moderate, the real issue is crowding out from sovereign debt issuance

Evaluating the outcome of the stress tests at the macro economic level, we believe the overall level will be moderate. The real issuance in terms of credit supply (cf. Economic News of July 22) is the huge amount of sovereign debt issuance in the pipeline, which invariably will crowd out private demand, both in terms of overall credit supply available and, in some cases, via higher interest rates.

Funding is the real issue for now…

Looking ahead, the key issue for both banks and governments is funding. In this context, the ECB – and of course the other European central banks - will continue to play a pivotal role.

The role of the ECB – liquidity, not capital

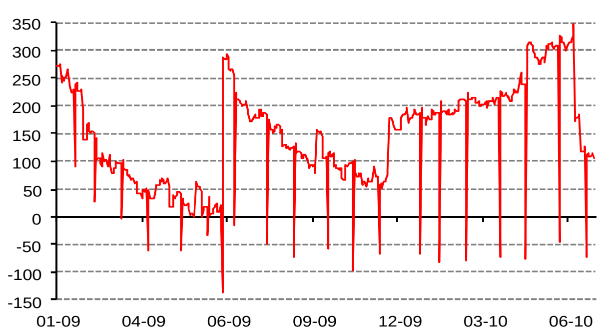
The ECB has consistently argued that if banks need additional capital, they should raise it in the capital market. Failing that, banks are meant to take advantage of the numerous schemes and facilities that national governments have put in place. However, the ECB has also made it clear that it stands ready to play its part in stabilizing financial markets. This has meant participating in the design of the stress tests, along with the EU Commission and CEBS.

More importantly looking forward, the ECB's role is as a provider of liquidity to the banking sector. Here, the ECB has already announced that unlimited funds at fixed rates and for three month maturities will be available at least until the end of September. Shorter-term refinancing operations (1-week and 1-month) also continue to be offered with full-allotment and at fixed rates, and will also remain in place until at least October. In our opinion, these latter operations will continue to be conducted in this way beyond the end of 2010.

In other words, if a bank faces difficulties financing itself in the interbank money market, the ECB stands ready to provide unlimited liquidity – provided, of course, the bank has appropriate collateral (which should not be an issue).

Chart 1: Still ample excess liquidity

Open Market Operations minus Autonomous Factors, R. R.



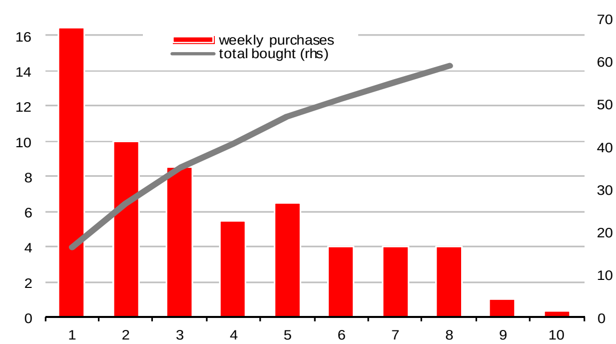
Source: ECB, SG Cross Asset Research/Economics

What is true for individual institutions is true for the system as a whole. If the stress tests lead to a renewed seizing-up of money markets – which is certainly not expected – the ECB has several possibilities to react. One, unlimited, fixed-rate liquidity for longer maturities could be extended beyond current plans. In the first instance that would apply to 3-month operations, but could potentially be extended to longer maturities.

If capital markets more generally were to be affected, there is the possibility to re-activate its bond purchasing program (the Securities Market Program, SMP), which could also be extended to private sector securities (the original plan always included this possibility). However, given the ECB's desire to keep the government bond purchases separate, and to sterilize them, there is probably a better chance that the Covered Bond Program could be extended, which specifically aimed at supporting European banks' funding.

Chart 2: SMP can be increased

ECB Government Bond Purchases €bn)



Source: ECB, SG Cross Asset Research/Economics

…medium-term deleveraging is the challenge

Overall, the medium term requirement for both banks and sovereigns is to strengthen balance sheets. This will entail several years of efforts and, in our opinion, there will be several bumps in the road ahead. Consequently, we see no fast tack narrowing of intra-euro area sovereign spreads. Moreover, markets are set to remain cautions on banks issues. In total, this on-going deleveraging process will act as a dampener on the pace of economic recovery.

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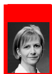
Head of Global Economics
Michala Marcussen
(44) 20 7676 7813
michala.marcussen@sgcib.com

Euro area


Klaus Baader
(44) 20 7676 7609
klaus.baader@sgcib.com


Olivier Gasnier
(33) 1 42 13 34 21
olivier.gasnier@sgcib.com


James Nixon
(44) 20 7676 7385
james.nixon@sgcib.com

United Kingdom


Brian Hilliard
(44) 20 7676 7165
brian.hilliard@sgcib.com

Americas


Stephen Gallagher
(1) 212 278 44 96
stephen.gallagher@sgcib.com


Aneta Markowska
(1) 212 278 66 53
aneta.markowska@sgcib.com


Alejandro Cuadrado
(1) 212 278 73 13
alejandro.cuadrado@sgcib.com

Asia Pacific


Glenn Maguire
(85) 221 66 5438
glenn.maguire@sgcib.com


Takuji Okubo
(81) 355 49 5560
takuji.okubo@sgcib.com

Thematic Research


Véronique Riches-Florès
(33) 1 42 13 84 04
veronique.riches-flores@sgcib.com

Research Associates

Lydia Boussour **Pauline Lez** **Martin Rose** **Wei Yao**

Mehreen Khan

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