EUROPEAN BANK STRESS TEST RESULTS

A systemic positive, despite the oversights

- We were biased to being long risk going into the tests: expectations were low, worst-case capital holes could, in our view, be filled within the scope of existing facilities, transparency would be a major positive, and weak banks would be forced to recapitalize. We believe the tests fell short in many respects, but we nevertheless have a positive view of the outcome. On the one hand, the tests exceeded expectations concerning disclosure of sovereign bond holdings. The majority of banks should be able to fund more cheaply. On the other hand, the tests were not stringent enough. Investors will perceive the banks that barely passed to be undercapitalized; we expect poor spread performance from those names and they are likely to continue to face high funding costs.
- In our view, the positives (creation of transparency) outweighs the negatives (too little forced capitalization). The majority of European financial risk in credit indices has been issued by banks that cleared the tests by a wide margin, where capitalization is not a concern, and where transparency is a key positive. The risk to our view is that, while systemic fears are likely to subside, the soft-handedness of the stress tests are likely to leave concerns over the capitalisation of some specific institutions – and that these idiosyncratic problems become so large that they overwhelm the systemic benefits.

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The context: Banking on governments

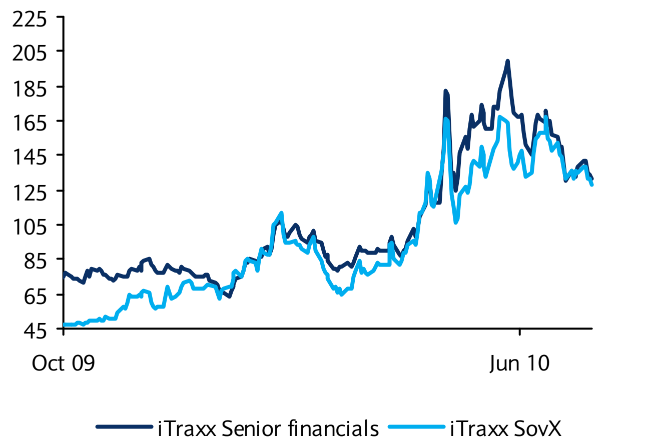
The European credit market has been dysfunctional for the past several months. At the heart of the problem have been the interlocking issues of a weak banking sector and over-indebted governments.

To slow the process of deleveraging and to stabilise lending in early 2009, governments assumed risk from banks – in the form of asset purchases, government guarantees of bank debt issuance, and direct capitalisation of banks with state money. The banks, in turn, financed burgeoning deficits by investing in government bonds, rationally playing a carry trade by borrowing cheaply in short-term markets at yields that were depressed by loose monetary policy and the provision of near-free liquidity from central banks.

The stability that was supposed to be injected into the financial sector did not come to pass because of bank holdings of government debt. Investors quite sensibly perceived that banks and governments were in the same boat, and that the boat was sinking.

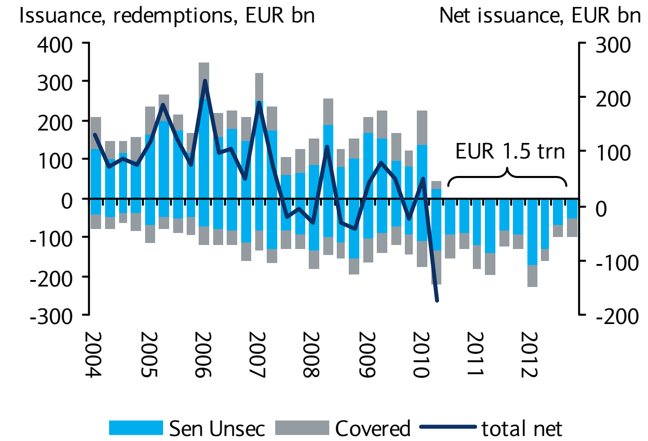
This took place against a backdrop of deteriorating real estate in some countries (especially Ireland and Spain) and the sense that European banks never took the losses that UK and US banks did in 2009; partly because of more lenient stress tests, whose results were not publicly disclosed, and partly because of accounting changes which permitted banks to shift distressed assets from mark-to-market trading books into more opaque banking books.

Figure 1 Higher sovereign spreads have raised the floor for bank funding costs…



Source: Markit

Figure 2: … making senior unsecured debt issuance unattractive for most banks



Source: Dealogic

The most important symptom of risk aversion to banks has been a shutdown in the senior unsecured funding market

If these were the causes of risk aversion towards banks, the most important symptom has been a shutdown in the senior unsecured funding market. We believe the vast majority of banks never lost access to funding, they just found it too expensive. Since there was not enough transparency into assets, and in particular holdings of government debt, investors assumed the worst for all banks. This lack of transparency systemically raised funding costs to a level that most banks found unappealing, especially given the existence of other, cheaper sources of funding like deposits, covered bonds, and ECB repo borrowing. The amount of debt to be refinanced (supply) was not so much the problem as the thinning of demand and the consequent rise in spreads in the primary market.

Risk/reward suggested being long going into the results

We felt the creation of transparency alone would be a major positive

We were biased to being long risk going into the tests. We felt expectations were low, that worst-case capital holes could be filled within the scope of existing facilities, and that the creation of transparency alone would be a major positive (see *European bank stress tests: A preview*, 14 July 2010). Forced recapitalization of weak banks was also critical. Risks to our view centered primarily on the concern that not enough transparency would come out of the process, and that the tests would be too lenient, allowing too many banks to escape having to raise capital.

Interpreting the results

Indeed, the degree of transparency surprised to the upside…

We believe the tests fell short in many respects, but we nevertheless have a positive view of the outcome. On the one hand, the transparency we hoped for materialized: investors now have bank-by-bank disclosures of holdings of governments bonds from each country, and they know where (trading or banking books) these exposures reside. We believe the outcome of this – for those banks which cleared capital hurdles by a long margin – will be a decrease in funding costs and an increase in senior unsecured issuance. Our equity colleagues believe that HSBC, BNP Paribas, RBS and Swedbank are particularly positioned to benefit from this effect.

… although the tests were not stringent enough

On the other hand, we do not see the tests as having been stringent enough. We estimated a potential capital hole of almost EUR80 billion, the EUR4 billion hole that CEBS identified borders on the absurd. The key differences between what we believe to have been investor (and our) expectations, and those identified by regulators, are that:

- Regulators used a capital threshold of 6% tier 1 rather than *core* tier 1;
- Haircuts on sovereign debt were applied to trading books but not banking books; and
- We used US-style (SCAP) stringent loss assumptions, while CEBS used parameters more appropriate for a mild recession.

In our view, investors will take a negative view of the handful of banks that only cleared the tests by a small margin – these banks will, in the eyes of investors, remain undercapitalized. They will therefore not benefit from a reduction in funding costs.

Trading the outcome

Overall, from a strategy perspective, we believe the positive (creation of transparency) wins out over the negative (too little forced capitalization). The majority of financial credit risk – in the iTraxx senior financials index but more so in the European bond indices – is issued by names that cleared the tests by a wide margin, where capitalization is not a concern, and where the transparency the tests created is a major positive.

Sell iTraxx senior financials protection and buy protection on names which barely passed the tests

We recommend investors consider taking advantage of what we expect to be a decrease in systemic financial tail risk by selling iTraxx senior financials, while shorting names that barely passed the tests and where we expect concerns over capitalization to linger. In particular, from that universe of weakly-passing names we would single out those that would have failed the tests if sovereign exposure in banking books had been tested. We cannot rule out a scenario in which markets punish these institutions with higher funding costs until they raise more capital.

Figure 3 shows what the banks' Tier 1 ratios would look like if the sovereign exposure in their banking books is also stressed (ie, in addition to the sovereign exposures in their trading books). The number of banks failing the 6% hurdle Tier 1 ratio would rise to 22 from 7. The total capital shortfall would increase to at least EUR12.6bn[1] from EUR3.5bn. In our view, the main CEBS sovereign haircut that is considered too low by the markets is the 23% for Greece. Applying a 30% haircut (as implied by CDS prices) would increase the total capital shortfall to at least EUR14.4bn, although the number of banks failing the 6% hurdle Tier 1 ratio would remain unchanged. The following banks stand out:

- Both Credit Agricole and BPCE come out well. Considering that Credit Agricole in particular had suffered from its exposure to peripheral Europe, we believe that its spreads should narrow on the back of the stress tests. We recommend their Tier 1 bonds.
- Santander impresses with an adjusted Tier 1 ratio of 9.4%. We recommend its Lower Tier 2 bonds.
- We note that both RBS and Lloyds Banking Group rank highly. Although they were not expected to show significant exposure to peripheral European sovereign bonds, this result may help sentiment, already improved by their recovering stand-alone creditworthiness. We see compelling value across their capital structures.

[1] As Hypo Real Estate Holding and Agricultural Bank of Greece had not yet disclosed their sovereign exposures before the publication of this note, we were unable to calculate their capital shortfall under this more adverse scenario

- Alpha Bank ranks well above its domestic peers with a stressed Tier 1 ratio of 6.6%, reflecting the relative modest size of its Greek government bond portfolio (EUR4.2bn at end-1Q10 – 79% of equity, 6% of total assets).

Sell protection on iTraxx Europe versus CDX

Non financials should also benefit – to the extent European assets have generically been shunned (eg, European equities, or iTraxx Main vs the US CDX.NA.IG), that the systemically important financial institutions are likely to benefit from lower funding costs, that credit provision should therefore increase, and the risk of a large bank failure is diminished – we expect iTraxx Main to tighten more than CDX.

The key risk to our view is that while systemic fears are likely to subside, the soft-handedness of the stress tests should leave concerns over the capitalization of some specific institutions – and that these idiosyncratic problems become so large that they overwhelm the systemic benefits. This is not our base case expectation, but a tail risk.

Figure 3: Tier 1 ratios including and excluding banking book stress

	Excluding banking book stress (1)	Including banking book stress	Capital shortfall (EUR mn)
		Above 8% Tier 1 ratio	
Banca March	19.0%	18.9%	0
Bilbao Bizkaia Kutxa	14.1%	13.1%	0
Rabobank	12.5%	12.0%	0
RBS	11.2%	10.5%	0
HSBC	10.2%	10.0%	0
Banco Guipuzcoano	10.6%	9.9%	0
SEB	10.3%	9.8%	0
Swedbank	9.9%	9.7%	0
Nordea	10.1%	9.7%	0
Societe Generale	10.0%	9.4%	0
Santander	10.0%	9.4%	0
ABN / Fortis Bank Nederland	9.9%	9.3%	0
SNS Bank	10.5%	9.2%	0
Lloyds Banking Group	9.2%	9.1%	0
HSH Nordbank	9.7%	9.0%	0
BNP Paribas	9.6%	8.9%	0
Dexia	10.9%	8.9%	0
SHB	8.9%	8.8%	0
Credit Agricole	9.0%	8.7%	0
ING Bank	8.8%	8.3%	0
Unicaja	9.0%	8.3%	0
BPCE	8.5%	8.2%	0
BPI	10.2%	8.1%	0
BBVA	9.3%	8.0%	0
Commerzbank	9.1%	8.0%	0
BCP	8.4%	8.0%	0

Figure 3: Tier 1 ratios including and excluding banking book stress, cont'd

	Excluding banking book stress (1)	Including banking book stress	Capital shortfall (EUR mn)
		Between 6-8% Tier 1 ratio	
BayernLB	8.8%	7.9%	0
Intesa SanPaolo	8.2%	7.6%	0
DeKa Bank	8.4%	7.6%	0
KBC	9.4%	7.5%	0
Danske Bank	10.0%	7.4%	0
Caixa Geral de Depositos	8.2%	7.4%	0
RZB	7.8%	7.3%	0
CAM (2)	7.8%	7.2%	0
Unicredit	7.8%	7.2%	0
Erste	8.0%	7.1%	0
Bank of Ireland	7.1%	7.0%	0
Caixa (2)	7.7%	6.8%	0
Alpha Bank	8.2%	6.6%	0
Breogan (2)	7.2%	6.6%	0
WestLB	7.1%	6.5%	0
Sabadell	7.2%	6.5%	0
UBI	6.8%	6.5%	0
Mare Nostrum (2)	7.0%	6.5%	0
LB Hessen-Thuringen	7.3%	6.4%	0
Bank of Cyprus	8.0%	6.4%	0
BES	6.9%	6.3%	0
Vitoria y Alava	7.0%	6.3%	0
Bankinter	6.8%	6.3%	0
Banco Popular	7.0%	6.3%	0
LB Baden-W	8.1%	6.3%	0
Zaragoza etc.	6.7%	6.0%	0

Figure 3: Tier 1 ratios including and excluding banking book stress, cont'd

	Excluding banking book stress (1)	Including banking book stress	Capital shortfall (EUR mn)
		Below 6% Tier 1 ratio	
EFG-Eurobank	8.2%	5.8%	-126
Allied Irish Bank	6.5%	5.6%	-296
Banco Guipuzcoano	6.1%	5.6%	-35
Monte dei Paschi di Siena	6.2%	5.4%	-683
Caja Sol (2)	6.0%	5.4%	-121
Jupiter (2)	6.3%	5.4%	-1,318
CAI (2)	6.1%	5.4%	-92
Caixa d'Estalvis de Pollensa	6.2%	5.2%	-2
Marfin	7.1%	5.1%	-222
Banco Pastor	6.0%	5.0%	-196
NordLB	6.2%	4.7%	-1,354
CajaSur	4.3%	4.2%	-221
Espiga (2)	5.6%	4.0%	-587
Banca Civica	4.7%	3.9%	-624
Unnim (2)	4.5%	3.8%	-401
National Bank of Greece	7.4%	3.5%	-1,765
Diada (2)	3.9%	3.3%	-1,335
Piraeus Bank	6.0%	3.0%	-1,125
Hellenic Postbank	10.1%	-1.2%	-499
Caja de Ontinyent	6.6%	-4.2%	-71
Hypo Real Estate Holding	4.7%	n/a	< -1,245
Agricultural Bank of Greece	4.4%	n/a	< -243
TOTAL CAPITAL SHORTFALL			**-12,560**
If Greece @ 30% haircut			**-14,360**

Note: The following banks are not included in the above table: Jyske Bank, Sydbank, Pohjola Group, OTP Bank, Jelzalogbank, Banque et Caisse d'Epargne de l'Etat, Banque Raiffeisen, Bank of Valletta, PKO Bank, NLB. In addition, the following banks have as of yet not disclosed their sovereign bond holdings: Deutsche Bank, Deutsche Postbank, Standard Chartered, DZ Bank, HRE Holding, Landesbank Berlin, WGZ Bank and Agricultural Bank of Greece
1) CEBS 'Adverse scenario with sovereign shock' but excluding direct banking book stress.
2) These are the project names of mergers between cajas that are currently taking place. For the names of the participating cajas, please refer to the CEBS press release of 7 July 2010.
Source: CEBS, central banks, companies, Barclays Capital

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