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European Bank Stress Tests….

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The long awaited bank stress tests do not seem to have been that stressful after all. This is not surprising. The last thing the authorities would have wanted to do was to set a series of assumptions that would have led to a broad failure across the Euro area, as this could only do more damage to the already frail markets. The most controversial area surrounds the treatment of the banks Sovereign debt holdings. The haircuts on these bonds only applied to the banks trading books, whereas the majority of these bonds are held on the banking books. In some ways this is consistent with the EU's comments that no EU sovereign will be allowed to fail, although of course if there is a Sovereign failure at a later date where the debt is held will make no difference to the actual loss that would be taken.

The banks that do fail the tests will not be allowed to fail in the real world. They will no doubt either raise capital from the private sector or more likely from their respective governments, as no-one is prepared to undertake another Lehmans like experiment.

This is an important point. The key differential in the markets since the announcement of the stress tests is that there is a lot less short-term concern regarding the European government bond market. Spain has issued a few successful issues and that was the most closely watched government market as it was seen as being the one that had to hold, because if Spain got into trouble then we could have faced a meltdown situation.

So the majority of banks have passed the tests and the likes of Hypo, the Greek ATE and some of the Spanish Cajas have failed, all as previously rumored, but the key to the market reaction is how credible these tests are thought to have been. Some are saying that they are not as credible as the US stress tests. Certainly from some viewpoints this is true; the US tests had a set purpose and a known solution to any problems, the European version has not. However, the US did not have to take into account potential sovereign problems, thus it is not easy to compare the two.

My view is that whilst the stress tests do not take into account the worst case scenario of multiple sovereign failures, we know what the impact of such a disastrous backdrop would be anyway; that is a complete collapse of the western worlds financial system! The EU governments will not allow banks to actually fail in the market, thus it is the sovereign bond market that is key in the short term, because there is not anyone who can bail out the governments (aside from printing money). Thus within a week I think the stress tests will be forgotten and the market will be focusing on the earnings season and economic data. As for the banks, they will be looking at the next test, which is can the sector as a whole borrow in the market at a cost which means that they can contribute to the economy as a whole. We know they will be supplied with liquidity to survive, but it is returning to a normal market condition where banks can borrow as regular borrowers that is required for them to play their proper role in a fully functioning economy. The stress tests do not begin to answer that question. But if the markets react in a neutral or positive manner, then they will have done their job.

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