



Unravelling the EU Bank Stress Tests

Risk Insights

- At first sight, the recent EU-wide bank stress tests were passed with flying colours (amid enhanced transparency and incentives for banks to develop plans for emergency funding), and financial markets reacted fairly positively.
- However, we believe that the tests were only partially successful, with many negative aspects clouding the results; in particular, we do not think that the test criteria were stringent enough.
- Weak bank lending activity could further erode the European economic recovery.
- In the medium and long term, restructuring in the European banking sector will further force countries to change their economic growth models, with implications for investors and traders.

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The tests appeared to have been passed with flying colours...

The Stress Test Results

In late July the Committee of European Banking Supervisors (CEBS) announced the results of the long-awaited, EU-wide bank stress tests that had been carried out in recent months. CEBS had conducted the tests in co-operation with the European Central Bank (ECB), the European Commission and national supervisory authorities.

On the surface level, the tests were passed with flying colours: of the 91 leading European banks tested (accounting for around 65% of European bank assets), only seven failed the severest of the stress scenarios. Five of those were Spanish savings banks (cajas). Germany's Hypo Real Estate and Greece's ATEbank were the other two institutions to fail. Under the test criteria, banks had to prove capable of keeping their Tier One capital ratios (the ratio of a bank's capital to its risk; a core measure of financial strength) above 6% in order to pass the tests.

Test Results of the Seven Banks That Failed

Bank	Origin	Tier 1 Capital Ratio 2009 (%)	Tier 1 Capital Ratio 2011 (%)	Capital Requirement (EURm)
ATEbank	Greece	8.4	4.4	243
Banca Civica	Spain	9.6	4.7	406
Cajasur	Spain	1.8	4.3	208
Diada	Spain	6.6	3.9	1032
Espiga	Spain	8.6	5.6	127
Hypo Real Estate	Germany	9.4	4.7	1245
Unnim	Spain	7.2	4.5	270

**Note: Tier 1 Capital Ratio 2011 is the projected ratio under the severest stress test scenario
Sources: Central banks; individual banks; D&B*

In addition to the seven failures, there were several banks that almost failed (and which could come under pressure to raise capital levels), including Monte dei Paschi from Italy, Ireland's Allied Irish Banks, and Postbank from Germany. However, many of the banks that failed or almost failed the tests are being restructured at the moment; for example, the Spanish banking landscape is likely to look very different by the end of the year owing to the consolidation process currently underway in the banking sector. Hence, we believe that the actual number of potential failures is not that relevant given that many of the banks will have been taken over by the end of the year anyway, especially in the Spanish savings bank sector.

The overall capital shortfall potentially faced by the seven banks that failed the tests amounts to just EUR3.5bn. By comparison, last year's stress tests in the US (covering 19 banks) revealed shortfalls amounting to USD75bn. The US test results were welcomed by financial markets at the time, as the surprisingly large need for recapitalisation that was identified gave the tests credibility, and banks immediately started raising capital to improve capital adequacy ratios.

...but the results were not surprising given developments in the run-up to the tests

How Did Financial Markets Respond?

Bond, equity and currency markets remained fairly calm. Bank shares did not fall significantly; the euro remained stable; and bond yields for euro-zone countries did not increase. However, this should not come as a surprise given that the test results did not reveal major needs for bank recapitalisations and were in line with investors' expectations.

Why Did So Few Banks Fail?

Firstly, the timing of the EU stress tests is important. A lot of the banks tested had already been recapitalised by government support schemes in late 2008 and throughout 2009; thus, the EU tests were carried out on already improved bank balance sheets, whereas the US tests last year were carried out on banks in need of recapitalisation. Tellingly, most of the EU banks that failed the tests are already in the process of major restructuring to improve their health in the medium to long term. Secondly, many EU banks had strengthened capital buffers in advance of the testing exercise in order to avoid additional financial market tensions. Lastly, the key aim of the testing exercise was not to expose major recapitalisation needs (as was the case in the US tests), but to increase the perception of transparency and credibility in the EU's financial sector.

Were The Test Criteria Strong Enough?

The tests did not properly account for the risk of a sovereign debt default...

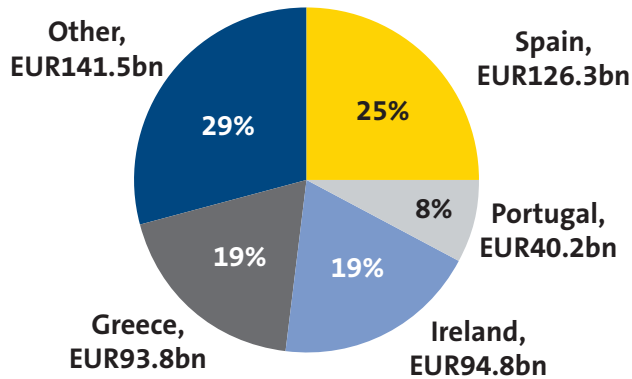
One of the key questions surrounding the tests was whether the testing criteria would be strict enough to provide meaningful results. D&B Country Risk Services believes that the main problem of the tests was that they did not properly account for the risk of a sovereign debt default in the euro-zone in 2010-11. However unlikely such a scenario may be, we believe that it should have been included in the stress tests, as the exercise was supposed to test banks' ability to withstand severe shocks to their asset quality. Instead, an increase in sovereign risk was only tested in a limited way by marking down sovereign securities to the prices seen in May this year (when the Greek sovereign debt crisis had escalated); prices have recovered slightly since the adoption of a large EU-IMF rescue package for vulnerable euro-zone members (the so-called PIIGS: Portugal, Ireland, Italy, Greece, and Spain). We believe that such a debt default and/or a sharp markdown in bond prices would lead to major recapitalisation needs among many European banks that hold government bonds on their balance sheets.

Another problem lies in the fact that not all sovereign bonds have been tested: the assets tested were only those sovereign bonds that are traded (so-called mark-to-market), rather than those held to maturity by banks. However, in order to give a more adequate picture of European financial sector risk beyond the short term we believe the hold-to-maturity bonds should have been included in the stress tests.

...and the tests' scope was too limited

D&B is also concerned that the tests' scope was not sufficient to fully test the health of European banks. This is because the tests focused on asset quality rather than liquidity risks. Many European banks continue to struggle to raise money on the international capital markets to fund their operations, as lenders have become cautious in the wake of the Greek debt crisis. As a result, European banks (especially those from the PIIGS) still rely heavily on cheap ECB liquidity. For example, according to data from Portugal's central bank, local banks sourced EUR40.2bn at the ECB in June, almost four times as much as in June 2009. Data from the Spanish central bank show that the borrowing needs of Spanish banks are even larger: in June they borrowed EUR126.3bn from the ECB, up from EUR85.6bn in May; an increase of almost 50% within only one month.

Destination of ECB Lending, June 2010



Sources: Central banks; D&B

That said, D&B believes that the tests were not entirely based on weak criteria. We think that they were quite solid in terms of the shock scenario for economic activity. The tests assumed a scenario in which economic activity in the EU would be a cumulative 3 percentage points lower than the European Commission's latest economic growth forecasts (1.0% in 2010 and 1.7% in 2011). This scenario is more severe than the one used by the US stress tests last year, and can therefore be regarded as sufficient to test the effects of a double-dip recession on banks' loan books.

Conclusion

Overall, we believe that the tests were only partially successful. Positively, they enhanced transparency in the financial sector, restored some confidence in national and EU-wide banking supervision, and helped banks to develop plans for emergency funding in the event of severe shocks. However, on balance we believe that the test criteria were not stringent enough to comprehensively test the health of the European banking sector, especially as they did not account fully for sovereign and liquidity risks.

What Does This Mean To D&B Customers?

A lot depends on whether banks will be able to maintain their current capital adequacy ratios. Country Risk Services believes that the risk of a rise in non-performing levels in 2010-11 will remain a source of concern, as disposable incomes in many European countries will be undermined by governments' need to reduce spending and raise taxes in order to reduce budget deficits. Consequently, payment risks in the financial sector will remain elevated.

Exporters to and potential investors in European countries will continue to face the risk of a fragile economic recovery, which could be exacerbated by weak bank lending activity. Although we believe the risk of another credit crunch in Europe in 2010-11 is low, bank lending to firms and households will remain constrained by banks' ongoing liquidity problems. As the ECB slowly withdraws its emergency liquidity funds for banks, they will increasingly turn to money markets for funding; European banks (unlike their US counterparts) rely on interbank lending rather than raising funds in international

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Weak bank lending activity could further erode Europe's fragile economic recovery

Restructuring in the banking sector will have significant implications for investors and traders

capital markets to source the bulk of their funding needs. There is a risk that interbank lending will not recover sufficiently to replace ECB emergency funds.

Finally, a broader question will remain over the medium- and long-term growth models in many European countries, especially the PIIGS. For example, countries such as Ireland and Spain, which have depended on the availability of cheap credit to firms and households for economic growth for many years, will undergo a major structural change in order to reduce household and government indebtedness (as noted in our special paper from 17th May entitled *The Fallout from the Debt Crisis in the Euro-zone*); this process will be accompanied by major changes in the banking sectors, such as mergers and acquisitions in the Spanish savings bank sector, which will reinforce these countries' need to change their growth models. This could have major implications for trade and investment prospects in these countries in the medium term, as households and companies cannot expand their spending and investment activities in the way that they have done in the past. We therefore recommend that customers monitor their exposure to European countries carefully.

D&B Country Risk Services

At D&B Country Risk Services we have a team of economists dedicated to analysing the risks of doing business across the world (we currently cover 132 countries). We monitor each of these countries on a daily basis and produce both shorter analytical pieces (Country RiskLine Reports), at least one per country per month for most countries, as well as more detailed 50-page Country Reports. For further details please contact Country Risk Services on **+44 (0)1628 492595** or email **CountryRisk@dnb.com**.

Additional Resources

The information contained in this publication was correct at the time of going to press. For the most up-to-date information on any country covered here, refer to D&B's monthly *International Risk & Payment Review*. For comprehensive, in-depth coverage, refer to the relevant country's Full Country Report.

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