TD Bank Financial Group

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The Committee of European Banking Supervisors (CEBS) and the 91 participating banks have released the results and details of the much-awaiting European stress tests and completed their press conference on the details.

The full reports can be found here: http://stress-test.c-ebs.org/firstresults.htm
The summary of bank-by-bank results can be found here: http://stress-test.c-ebs.org/documents/Listofbanks.pdf

Overall, our feeling is that the tests were on the lenient side with:

- Seven banks officially failing - by ending with an overall Tier 1 capital ratio below 6% as a result of the adverse scenario
- An additional 11 banks falling between 6-6.5%
- Only EUR3.5bn in capital shortfalls that would need to be raised.

But we also feel that the structure and details released make it difficult to make a truly informed analysis immediately so final judgments will need to wait until further into the weekend, if not later. But it does appear that sufficient details have been released for equity analysts to stress banks based on their own assumptions, which could ultimately give the market more direction than the official tests have provided.

The seven banks that have failed are five of the Spanish cajas/savings banks (Diada, Unnim, Espiga, Banca Civica, and Cajasur), Germany's Hypo Real Estate Holding (widely expected as it was nationalized during the global financial crisis), and the Agricultural Bank of Greece (ATE Bank). The Spanish central bank has confirmed that the cajas that failed the test will need to raise EUR1.85bn, with reports that FROB, the Spanish recapitalization fund, will likely be used to do this. ATE has confirmed they will go ahead with a planned capital raising, but full implications from failing the test is left up to national regulators and banks so further details should be forthcoming.

On the questions of sovereign debt holdings, the average haircut of 8.5% across the EU - with 23.1% on Greek debt, 14.1% on Portuguese, 12.8% on Irish bonds, 12.3% on Spanish bonds, and 7.4% on Italian bonds - is generally in line with the early rumours (table below). All countries did include some kind of haircut, including a 4.7% haircut on German bonds, but there are two general criticisms of this approach. First, if a country really were to default, these losses would obviously be much bigger and much more concentrated. So the real-world applicability of such a test have limitations. Second, the overwhelming majority of sovereign debt is held in accrual accounts of banks rather than in the trading books. The importance of this is that while trading books must be marked to market, the bonds held elsewhere on the balance sheet would only count against regulatory capital if there were a serious doubt about an ability to repay.

Table 2. Valuation haircuts to sovereign debt holdings as applied in the exercise

Country	Haircut value
Austria	5.6%
Belgium	6.9%
Cyprus	6.7%
Finland	6.1%
France	6.0%
Germany	4.7%
Greece	23.1%
Ireland	12.8%
Italy	7.4%
Luxembourg	6.9%
Malta	6.4%
The Netherlands	5.2%
Portugal	14.1%
Slovakia	5.0%
Spain	12.0%
Slovenia	4.2%
Denmark	5.2%
Sweden	6.7%
UK	10.2%
Czech Republic	11.4%
Poland	12.3%
Other non-euro area EU	*11.8%*
EU average	*8.5%*

Source: Stress test scenarios (see Annex 2 for more details)

One obvious initial comparator for these tests were the US stress tests completed in May 2009. Compared to the US tests, the coverage of banks is similar, as both tests covered about 2/3 of total assets of the banking sector. The economic assumptions were also fairly consistent, with about three percentage points shaved off of GDP growth over two years, with knock-on effects for unemployment and home prices. In both tests, government injections of capital would be included as regulatory capital, so TARP funds in the case of the US tests and Spanish FROB funds in the case of the European tests. And also both tests did limit the losses in the accrual accounts based on expectations of default.

Perhaps more interesting are the differences.

- For the US tests, there were significant increases in mortgage and consumer loan books, as home prices were assumed to fall that did feed into losses in accrual portfolios. As a result, $455bn of the $600bn estimated losses in the US tests came in the accrual loan portfolios, primarily residential mortgages and consumer loans, and only 22% of estimated losses came from the trading books.
- While both tests used an overall Tier 1 capital ratio of 6% as a benchmark for pass/fail, the US test supplemented this with a 4% ratio on Tier 1 common capital (i.e. common equity) as a better measure of a buffer against unexpected losses. While 10 of 19 US banks failed the US stress test, none of these failed the overall Tier 1 test, but rather it was a perceived lack of common equity that led to a requirement to raise US$185bn in new capital buffers. So comparing apples to apples, US banks had to raise no capital for failing Tier 1 ratios while European banks had to raise EUR3.5bn. But US banks were requested to alter the structure of their regulatory capital holdings while European banks were not. And 53% of US banks failed while 7.5% of European banks failed.

- For the US tests, what was worrying the markets were the holdings of MBS, securitized products, and mortgages. So, working through stress tests on probabilities of default to stress line-items of balance sheets was a bit more straight forward and believable, given that regardless of how bad the US economy would have become, you would have never had a total default of every US mortgage. In the European context, the market wanted to know what would happen if there was a 100% default on a particular country. This is more of a binary outcome and created a higher hurdle for these results to every truly satisfy the market, given we knew it was a political non-starter to show this. These European tests did assume some mortgage/consumer/commercial loan losses as a result of higher sovereign yields, leading to higher commercial lending rates, leading to higher loan losses based on the typical probabilities of default. But, in the European case, this was not a stress the market was largely concerned about.
- The U.S. tests also clearly included counterparty losses in order to test for systemic risks of one bank failure stressing other banks. The European tests do not seem to provide detail suggesting this was the case here.
- The European tests also allowed national regulators to tweak the stresses applied to banks in their jurisdictions and the full details on these separate circumstances is not yet clear. For example, the Spanish banks has to include an assumption of a 28% decline in nominal housing prices.

No stress test will ever be able to test for every possible ill. The biggest criticism that can be made of this test is that the market has been concerned about a sovereign default and that is not stressed. The fact that the German Landesbanken that are known to be in difficult straits, and only one Greek bank failed, in spite of these banks being highly exposed to any shocks to Greek sovereign problems, provides a sense that the tests were not terribly difficult. Stresses also depend not just on the binary outcome of sovereign default or not, but also the speed of market stresses, as problems that seem digestible over a two year or two month timeframe may not be sustainable if they happen over two weeks. But more importantly, with enough information on banks results and holdings, the market appears like it will be able to come to its own conclusions based on its own assumptions. For example, there have been some details on individual banks holdings on sovereign debt, and with more details still trickling in, markets will be able to see which banks could be particularly exposed to the sovereign default scenario and accurately price these risks into valuations. This could ultimately be the silver lining in these results, though we don't yet have enough information to know whether we will like what we find.

Overall, these stress tests move the market past a major hurdle that it has been looking forward to for some time. But we are left with a bit of a feeling of "Waiting for Godot" as we don't see much more direction now as to where markets feel they should go as a result of these findings. While EURUSD sold off in the initial moments of the release, two hours later as the CEBS press conference comes to a close, EURUSD is back to the previous close so the market too is saying it hasn't seen much in this. As a result, we will be left waiting for further headlines over the weekend and coming week.

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