Weekly Credit Brief
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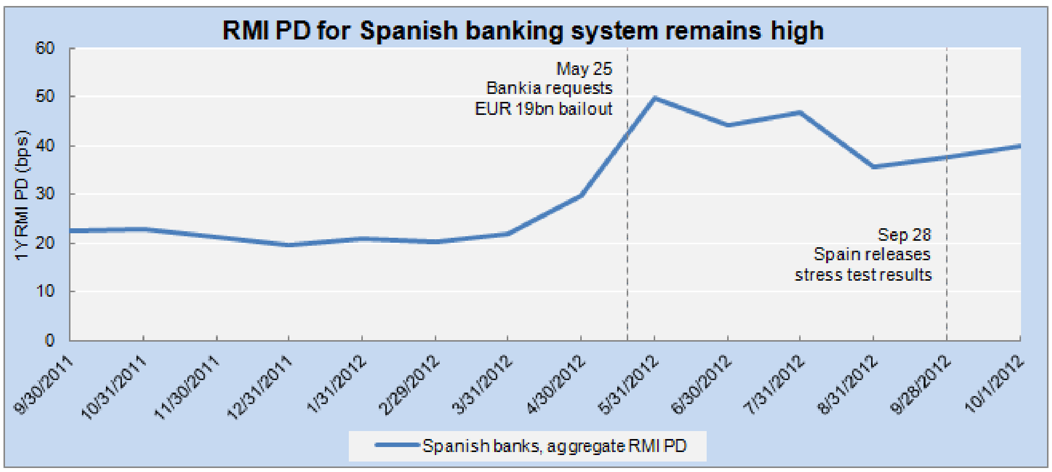
Story of the Week

RMI PD for Spanish banking system remains high following independent stress test

By James Weston

The 1-year aggregate RMI probability of default (RMI PD) for the Spanish banking sector remained elevated on October 1, after the government released the results of an independent stress test conducted by consultancy group Oliver Wyman on September 28. The report showed 14 Spanish banking groups needed EUR 53.7bn in total recapitalization, and the report will likely be used as a basis for calculating how much Spain will need to draw from a EUR 100bn bank bailout fund provided by the EU.

The figure was well below expectations, and is a strong credit positive for the Spanish banking sector. A recapitalization will restore some confidence in the sector, and significantly improve the solvency of the banking system. In addition, the report showed Banco Santander, Banco Bilbao Vizcaya Argentaria (BBVA), and CaixaBank, three of the largest Spanish banks, do not require additional capital. However, the sectoral aggregate RMI PD increased slightly on October 1, as market participants remain concerned about a number of the assumptions used in the stress test, and the overall health of the Spanish banking sector.



Lower adverse capital requirement: Following guidelines from the Bank of Spain and other European governmental bodies, Oliver Wyman used a Core Tier 1 ratio target of 9% under the base scenario, and 6% under the adverse scenario when calculating the recapitalization needs of each bank. This is based on an assumption that the macroeconomic conditions under the adverse scenario have a low probability of occurring. However, a number of market participants have suggested that the Spanish economy will likely deteriorate past the base case scenario in 2012. Calculations by Moody's suggest the Spanish banking sector needs between EUR 70bn and EUR 105bn in recapitalization funds, using a minimum Tier 1 capital ratio of 8% in both their base and adverse scenarios.

Growth assumptions: Moreover, market participants are concerned that the growth and unemployment assumptions used in the report were not conservative enough. The Spanish economy remains in a deep recession, with GDP contracting 1.3% in Q2, while unemployment increased to 24.6% in Q2. Continued economic contraction will likely lead to further increases in non-performing loans at Spanish banks, and curtail profitability, reducing the ability of the banking system to offset an estimated EUR 270bn in expected losses with new profit generation.

Excess capital buffer problematic: Oliver Wyman also assumed banks would be able to cover a portion of the expected losses with so-called excess capital, or funds derived from the sale of risk-weighted assets (RWA) by Spanish banks. Banks are expected to have EUR22bn of excess capital in the base scenario, which would increase to EUR 73bn in an adverse scenario. The report assumes banks will be able to delever rapidly in an adverse scenario, which is unlikely given the current low demand for eurozone bank assets, and the low potential recovery rates on such assets if the economy contracts rapidly.

Deposit outflows & bank liquidity: The report also assumed that deposits at Spanish banks would remain stable in the base scenario, and fall 3% per year in the adverse scenario. Based on current figures from the ECB, this could be an underestimate; total deposits at Spanish banks fell 6.75% year-on-year in August. Low profitability and an inability to sell assets amid the deposit outflows have led to a significant deterioration in liquidity in the Spanish banking sector. This is the primary reason why funding provided by the ECB to Spanish banks reached a record high of EUR 412bn in August.

Sources:
Asset quality review and bottom-up stress test exercise (Oliver Wyman)
Spanish Banks Beat Expectations (WSJ)
Spanish banks need more capital than tests find, Moody's says (Bloomberg)

In the News

FSA to oversee Libor in streamlining of tarnished rates
Sep 28. The recent Libor rate-fixing scandal may see oversight of Libor handed to the UK Financial Services Authority (FSA), in a move to restore confidence in the banking system. Measures contemplated by the FSA to cleanse the structure include stripping the British Bankers' Association (BBA) of its existing powers and setting up a neutral organization to accept the submitted rates. The plan includes encouraging more banks to submit quotes and cutting the number of Libor reference rates from 150 to 20 by phasing out maturities and currencies in which trading is thin. In addition, transactions of rate submitters will need to be recorded and externally audited to ensure the submissions are corroborated by trade data. These steps are expected to curb the misuse under the current system. (Bloomberg)

Japanese banks stake USD 6bn on electronics bailouts
Sep 28. Japanese Banks have agreed to provide financing to troubled electronics companies Sharp and Renesas, by providing more than USD 6bn in loans. Though the companies are experiencing ongoing losses, the banks will not force them into bankruptcy as providing further liquidity seems more viable if the lenders wish to recoup the loans already extended. Japanese electronics manufacturers have led the industry in the past, but have failed to retain their positions by investing less in research and development. Failure to keep up with innovations in the electronics market coupled with a strengthening JPY has made it hard for Japanese manufacturers to maintain profitability. Although the loans extended may provide short term respite to fund working capital needs; in the long-term these companies need to address problems with their core business areas in order to become viable again. (Reuters)

IMF Lagarde sees Greek finance gap beyond fiscal measures
Sep 24. IMF Managing Director Christine Lagarde said that the financing gap of Greece would not be merely solved by fiscal measures. Savings of EUR 11.5bn proposed by the Greek government will not be enough to put the EUR 130bn bailout package back on track. A financing gap has emerged due to the deteriorating macroeconomic situation and limited revenue collecting ability. Additional financing should come from Europe, or further debt restructuring may be needed. Lagarde has insisted that besides austerity cuts, structural reform of the Greek economy is a crucial step to drive down the country's debt in the long-term. (Bloomberg)

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