Credit Research Initiative

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Stress testing as a stimulus of European banks' performance

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In preparing for assuming banking supervision tasks in November 2014, the European Central Bank conducted the comprehensive assessment of 150 European banks. The results released on October 26, Sunday, identify 25 banks that technically failed the stress tests with a cumulative shortfall of EUR 24.6bn, out of which 13 need to come up with EUR 9.5bn (USD 12bn) in extra capital. The different bank numbers were mainly due to the actions taken by most of the failed banks to solve the problems since the end of 2013 that was the deadline of assessment. After this period and beginning of 2014, a dozen of the 25 have already raised EUR 15bn for repairs.

Country	Banks with Capital shortfall	Capital shortfall	Capital shortfall post net capital raised
Greece	Eurobank	4.63	1.76
	National Bank of Greece	3.43	0.93
Cyprus	Hellenic Bank Public Company	0.28	0.18
Italy	Monte dei Paschi di Siena	4.25	2.11
	Banca Carige	1.83	0.81
	Banca Popolare di Milano	0.68	0.17
	Banco Popolare di Vicenza	0.68	0.22
Belgium	Dexia	0.34	0.34
Austria	Oesterreichischer Volksbank Verbund	0.86	0.86
Ireland	Permanent TSB	0.85	0.85
Portugal	Banco Comercial Portugues	1.14	1.15
Slovenia	Nova Ljubljanska Banka	0.03	0.03
	Nova Kreditna Bank Maribor	0.03	0.03

Table 1: 13 Banks with Capital Shortfall (Amount in EUR bn). *Source: European Central Bank*

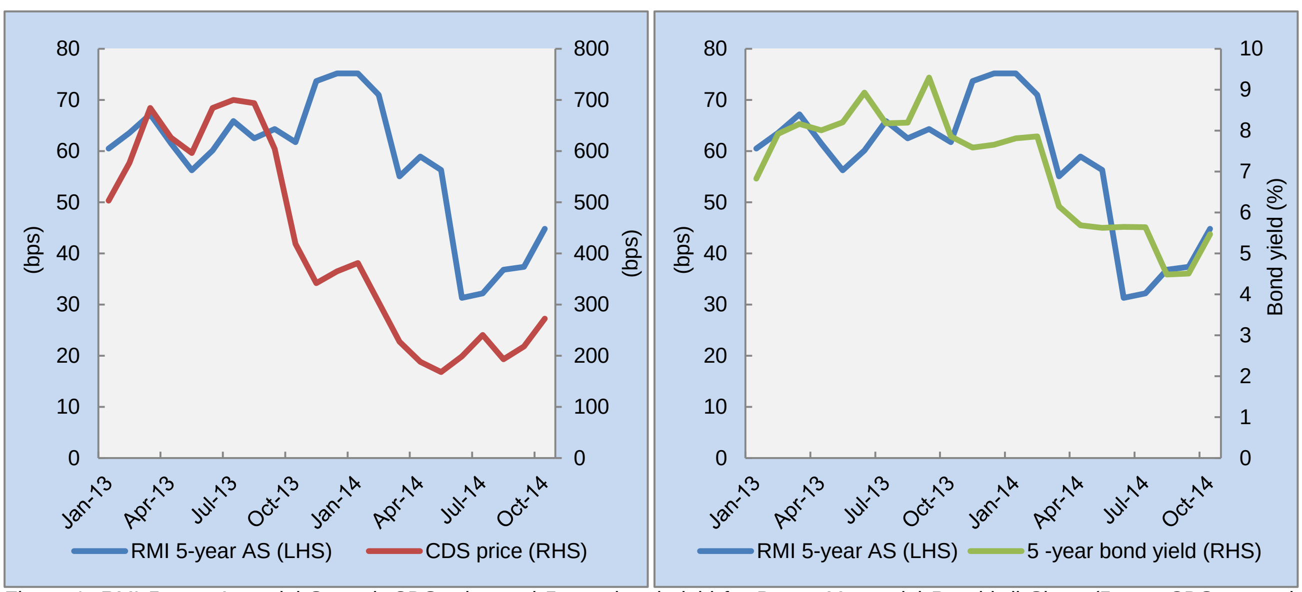

Figure 1: RMI 5-year Actuarial Spread, CDS price and 5-year bond yield for Banca Monte dei Paschi di Siena (5-year CDS on senior unsecured notes of Paschi and versus their respectively RMI Actuarial Spread based on a 40% recovery rate. Note that both banks' CDS are a EUR denominated derivative, while RMI AS is a USD-denominated instrument). Source: *Risk Management Institute*

As Table 1 illustrates, failures are concentrated among Italian banks as 4 banks still need to raise extra capitals, while Greece and Slovenia each has 2. Banca Monte dei Paschi di Siena (Paschi), the third-largest lender in Italy, was the worst performer in the stress test despite having the second-largest outstanding capital shortfall of about EUR 4.25bn. Unlike Eurobank, Paschi still needs EUR 2.1bn to survive a crisis even raising new capital after the stress testing period. Shares of this bank tumbled around 15% in the market on Monday. Paschi, thus faces the danger of a potential sale or merger scenario. Figure 1 shows the seemingly improvement of the Paschi's RMI 5-year Actuarial Spread (RMI 5-year AS) based on a 40% recovery rate from 2013 till now. The 5-year AS was introduced by RMI-CRI on 1 July 2014 as an alternative measure of the RMI PD. Unlike 5-year CDS or bond yield, the RMI AS is a pure measure of default risk, and is not influenced by risk premium and market liquidity, though they present similar trends.

Figure 2 shows the RMI 1-year PDs of these 19 Banks (i.e. 19 banks out of 25 banks are listed, while the private ones have no PDs available) who technically failed the stress test and 9 Banks with capital shortfall. Both of their RMI 1-year aggregate PDs are currently lower than they were in the beginning of 2013, while the decreasing trend of 19 banks' aggregate PD is more apparent than the 9 banks in 2014. This is because 10 out of the 19 failed banks have since raised enough capital after the stress test deadline bringing their aggregate PD down. On the contrary, the RMI 1-year aggregate PD of 9 banks, who are still faced with capital have been on a rising trend prior to the stress test results.

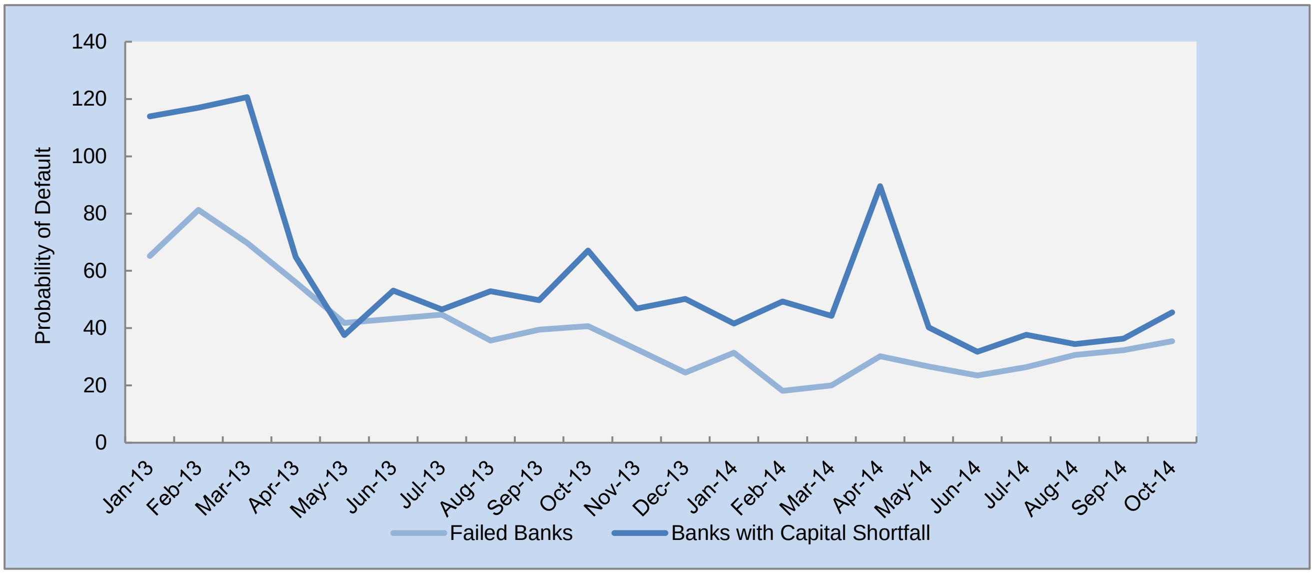

Figure 2: RMI 1-year Aggregate PD of 19 Failed Banks and 9 Banks with Capital Shortfall. Source: *Risk Management Institute*

The Comprehensive Assessment by the ECB was launched in 2013 and thousands of officials, accountants and consultants were involved in the stress testing process. This regulator process thus forces European banks to be proactive in raising capital ahead of the outcome.

ECB hailed its stress test a success, as they have encouraged the region's lenders to clean up their balance sheets in advance. To sum it up, for European banks to pass the stress test, banks are required to have high-quality capital of at least 8% of the risk-weighted assets, if the economy grows as expected over the next three years, and at least 5.5% if it turns into recession. This pre-determined percentage benchmarks reflect the riskiness of bank loans and other assets. The 13 Banks that are left with unfilled capital shortfalls will now have to explain to the regulators within a fortnight how they intend to overcome shortfalls and then they will be given up to 9 months to carry out their plans to fulfill the capital requirements.

Source:

Aggregate report on the comprehensive assessment (ECB)
About 25 Eurozone Banks to Fail ECB Stress Tests (WSJ)

Credit News

Troubles in China rattle western banks

Oct 27. The cross-border lending to China increased by USD 65bn in Q2 and was up 47% in the 12 months through the end of June. On the other hand, the cross-border lending claims in China rose 47% in the same period. Foreign lenders in China have been stung by a string of suspected fraud cases and problem loans in the country as Beijing investigates company executives and seizes assets in a crackdown on corruption. (WSJ)

Risk of "fiscal fiasco" in Australia if China runs off the rails

Oct 27. Deloitte Access Economics has released a new report on the potential impact on Australia of a more rapid slowing of GDP growth in China. The latter accounts for 38% of Australian exports, and if its growth rate falls to under 4% per annum Australia is likely to experience a recession. The forecasting firm warns that the Federal Government must do more to rein in the Budget deficit in light of this scenario. However Deloitte still maintains that the most likely outcome is growth in China of 7% or more, and a fall in Australia's terms of trade of 9.2% for 2014-15 before less dramatic declines of between 1% and 2% a year in the period to 2018-19. (The Australian)

Argentina debt default sours access to credit

Oct 25. Businesses are concerned that they would have less access to credit following the country's bond default in July. The government has yet to settle an agreement with creditors, who are suing the country to collect full bond repayment. President Cristina Fernandez is refusing payment, stating that it would lead to more lawsuits by restructured bondholders. Unless a settlement is made with the creditors, Argentinean firms cannot easily tap into international credit markets at the current low interest rates. (World Bulletin)

Investors approve bailout for China's first domestic bond default

Oct 24. Shanghai Chaori, an insolvent solar energy firm that suffered China's first domestic bond default approved a controversial debt restructuring plan that includes a state-backed, surprisingly generous settlement package for investors—but leaving many of its biggest creditors with hefty losses. The unusually generous solution to Chaori's bond default and the state's conspicuous presence in the process suggest that Beijing is now prioritizing economic and social stability over much-needed but painful financial reform. The company's other creditors aren't that lucky and many of them have voiced dissatisfaction and even fury with Chaori's treatment of their debt claims. (WSJ)

S&P 500 rising at five times GDP shows recovery priced in (Bloomberg)

Billionaire banned from markets increases DLF Risk (Bloomberg)

Singapore and China to start direct currency trading (CNA)

Korea risks economic own goal as stimulus fuels debt binge (SCMP) (Subscription required)

Regulatory Updates

Reputation risk rises on regulatory agenda

Oct 24. Regulators have expressed concern that banks could fail due to higher reputational risk. Banks are starting to feel the onerous burden of regulation, the Dodd Frank law appeared to be more punitive and corrective as banks have been subjected to fines and penalties aggregating in the tens of billions of dollars this year. The government is also considering whether banks are growing too large to be managed and if they should be made smaller and less complex. (Banking Exchange)

Fed to discuss regulatory relief with regional banks

Oct 24. Federal Reserve officials plan to meet with CEOs from 12 US regional banks which have between USD 50bn and USD 150bn of assets to discuss ways to reduce unnecessary regulatory burdens for banks. Under Dodd-Frank regulatory reform law, banks that have more than USD 50bn of assets must show how they would fare in stressful situations before they can increase dividends or buy back more shares. Completing these "stress tests" can be expensive and time-consuming for banks. Regional bankers have argued that they should not be regulated in the same way as the largest U.S. banks since they make most of their money from lending, where losses can be slow to appear, as opposed to trading, where big gains and losses can happen quickly. (Reuters)

Federal Reserve Board releases supervisory scenarios for 2015 capital planning and stress testing

Oct 23. The Federal Reserve Board released the supervisory scenarios that will be used in the 2015 capital planning and stress testing program. This includes the upcoming round of CCAR for 31 bank holding companies with USD 50bn or more of total consolidated assets as well as the stress testing required under the Dodd-Frank Act, which involves state member bank subsidiaries of CCAR participants and some companies with between USD 10bn and USD 50bn in assets. As in prior years, six bank holding companies with large trading operations will be required to factor in a global market shock as part of their scenarios. (Federal Reserve)

Fed reassures US banks on adverse scenario choice criteria (Risk.Net) (Subscription required)

Under Basel III rules, 36 EU banks would have flunked (IFR)

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