

## Stock Market Review



**Edward Rizzo**

Mr Rizzo is director of Rizzo, Farrugia & Co. (Stockbrokers) Ltd.

# The European banking stress tests

**T**he much anticipated stress test results conducted by the EU's new banking regulator, the European Banking Authority (EBA), were published late last Friday afternoon.

The EU-wide stress tests, carried out across 90 banks covering over 65 per cent of the total assets of the EU banking system, aimed to assess the resilience of European banks to severe shocks and their specific solvency to hypothetical stress events. The exercise required that the results and weaknesses identified are acted on to improve the resilience of the European financial system.

The EBA announced that eight banks failed the test with a total capital shortfall of €2.5 billion. They include five from Spain (Banco Pastor SA, Caja de Ahorros del Mediterraneo, Banco Grupo Caja3, CatalunyaCaixa and Unnim), two Greek banks (EFG Eurobank Ergasias SA and Agricultural Bank of Greece) and Austria's Oesterreichische Volksbank. The EBA requires each national supervisory authority to ensure that these banks present a plan within the next three months to restore their capital positions to at least five per cent.

Meanwhile, a further 16 banks only just managed to scrape through the test as their core Tier 1 ratio dropped below six per cent – only slightly above the minimum pass mark of five per cent. These 16 banks were given nine months (until April 2012) to raise more equity.

The data compiled by the EBA revealed that banks held €98.2 billion of Greek sovereign paper, €52.7 billion of Irish sovereign paper and €43.2 billion of Portuguese sovereign paper.

Similar to last year, Bank of Valletta plc was the local participant in the stress tests since it is the largest banking group in Malta. BoV announced that it comfortably passed the test as it enjoys strong capital buffers. BoV's Tier 1 Ratio (an indicator of balance sheet strength), decreased minimally to 10.4 per cent under the modelled adverse scenario, placing it among the soundest EU banks. The results achieved by BoV are important not only to the bank itself but also to the entire local banking and financial system. In recent years Malta's banking system has received much praise, especially since it proved its resilience in the face of adverse circumstances during the international financial crisis.

BoV's major competitor, HSBC Bank Malta plc, was not included in the recent stress tests. However HSBC Malta's majority shareholder, HSBC Holdings plc, achieved a ratio of 8.5 per cent,



**Miguel Angel Fernandez Ordonez, governor of the Bank of Spain, gestures as he announces four regional savings banks – Caja Mediterraneo, CatalunyaCaixa, Unnim and CajaTres – failed the stress tests, along with Banco Pastor, in Madrid last week. Photo: AFP**

ranking in 33rd place among the 90 banks.

Marfin Popular Bank of Cyprus (the largest shareholder of Lombard Bank Malta plc) was among the sixteen banks that scraped through the test. The estimated Core Tier 1 capital ratio of Marfin Popular Bank (the second largest bank in Cyprus) amounted to 5.3 per cent under the adverse scenario envisaged in 2012. Shortly after the announcement of these results, Marfin Popular Bank announced that it will proceed with a €2 billion asset reduction programme by mid-2012 to further strengthen its solvency position. Marfin said that the planned asset reduction would lead to an increase of 0.81 percentage points to its Core Tier 1 ratio by June 2012. Marfin's exposure to European sovereign debt as at 30 June 2011 was estimated at €3.9 billion, including €2.8 billion to Greek sovereign bonds, €380 million to Greek short-term bills and €50 million to Irish sovereign paper.

The strongest banks in the test were dominated by smaller lenders and institutions namely Spain's Banca March and Ireland's Irish Life and Permanent. However, the results of these institutions were boosted by the recent injection of government bail-out money. Scandinavian lenders also ranked highly with the Danish banks Sydbank in fourth position with a ratio of 13.6 per cent and Danske Bank in sixth place with a ratio of 13 per cent. BoV's ratio of 10.4 per cent placed the Maltese bank in a very respectable 12th place with other larger institutions such as BNP Paribas in 38th place (7.9 per cent), Lloyds Bank Group in 40th position (7.7 per cent) and Barclays Bank plc in 44th place (7.3 per cent). Among the surprises that emerged

last week were the results achieved by two of the largest banks in Spain (BBVA with a ratio of 9.2 per cent and Santander at 8.4 per cent) and Italy's Intesa Sanpaolo with a Tier 1 ratio of 8.9 per cent. While some international analysts noted that the clean bill of health given to these three large institutions could provide a timely boost to help relieve the recent funding pressure that these banks have experienced, there has also been widespread criticism in the international media on the way these tests were conducted.

The critics claim that the tests were not tough enough, mainly because they did not account for any sovereign failure even though Greece seems to be on the brink of default. The EBA assumed a 25 per cent write-down on 10-year Greek government bonds held in banks' trading books although the bonds currently trade at about 51 per cent of their 100 per cent nominal value. Some critics stated that assuming higher writedowns of 40 per cent on Greek bonds and 25 per cent on Portuguese and Irish debt, the additional capital requirements would increase to over €45 billion.

According to some analysts, if the pass mark were set at seven per cent (rather than five per cent), which is the minimum to be applied for banks from 2013 under the Basle III agreement, the requirement for extra capital at the European banks would rise to €41 billion. JP Morgan estimated that based on a seven per cent capital target, and including writedowns on sovereign debt in the banking book, 20 banks would need to raise capital, including Lloyds Banking Group (with a €25 billion shortfall), while French banks including Societe Generale would require €20 billion, and German lenders includ-

ing Deutsche Bank about €14 billion.

The recent tests may not succeed in reassuring international investors and this could place added pressure on international markets during the summer months.

It comes at a time when various experts are talking about the onset of another financial crisis. The focus seems to be on the contagion effect of the eurozone sovereign debt crisis which has started to spread to Italy.

However, few investors may have noticed that effectively the United States will run out of money to pay its bills on August 2 unless Congress agrees to a new deal to increase the national debt pile above the current ceiling of \$14.3 trillion.

While the US can easily be regarded as "too big to fail", rating agencies Moody's as well as Standard & Poor's have sent a warning shot in recent weeks to politicians and the markets. Moody's placed America's AAA-rating (which has been in place since 1917) under review for a downgrade while Standard & Poor's has taken a tougher view and announced that the US stands a 50 per cent chance of a downgrade in the next three months. Despite these warnings from the credit rating agencies, the yield on US government paper is still around three per cent presumably due to the "safe haven" status afforded to the world's largest economy.

The unprecedented effect of these events could send shock waves across global financial markets bringing back the severe consequences that were experienced only a few years ago following the bankruptcy of the US investment bank Lehman Brothers.

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