



## Summary

### European Banks Stress Tests

Results of EU-wide banks' stress tests were released late on Friday (23 July 2010) after the close of the European markets. Seven banks failed, of which five were from Spain, one was from Germany, and one from Greece. Failing the stress tests meant that these banks would be unable to maintain a critical Tier 1 capital ratio of 6% in the event of a recession and sovereign debt crisis. Going forward, these seven banks will shortly undergo restructuring and recapitalization plans, working closely with their national supervisors.

Generally, market reactions were muted, indicating that neither the worst fears nor greatest hopes were realized.

There were some market criticisms about the European Banks stress test exercise. Market analysts suggested that the testing was not very rigorous with the tests set in such a way that most of them would pass the test. Another major criticism against the European Banks stress test exercise is that it only assessed the potential losses on government bonds the banks trade, rather than those held in their banking book. That meant that the tests ignored the majority of banks' holdings of sovereign debt.

We believe that the results of the stress tests are useful and should not be dismissed for the reasons below.

Firstly, the amount of disclosures has been impressive such as the detailed data on most banks' exposures to EU-27 sovereigns, on a country-by-country basis. This enables the market to estimate the capital needs of the European Banks using their own assumptions. Secondly, though the market questioned the credibility of the stress tests due a smaller than expected aggregate capital shortfall, we believe this low figure is partly due to the capital injection of €236 billion from the EU governments over the last 18 months. Thirdly, the stress tests were robust enough to provide reassuring information about the ability to withstand a more severe economic scenario. Lastly, another benefit of the European Banks stress tests is the closer cooperation within EU which represents a positive move towards reinforcing European unity.

The Euro area sovereign/banking crisis appears to have turned a corner during the last few weeks as the market is becoming increasingly confident that the European Stabilisation Mechanism, ECB's responses, fiscal consolidation and reforms are putting Europe on a firmer platform to deal with the debt crisis.

The mixed results from the European Banks stress tests are not likely to distract the markets from this positive trend. While markets may be disappointed over the sovereign risk assumptions, the impressive data disclosures and the adverse scenarios simulations should help improve confidence in peripheral economies like Spain and Ireland.



BEST ONSHORE FUND HOUSE  
(SINGAPORE)

Asia Asset Management  
THE JOURNAL OF INVESTMENTS & PENSIONS  
BEST OF THE BEST AWARDS  
BEST RETAIL HOUSE (SINGAPORE) 2009



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## Equity Market Comment

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### Results of the European Banks Stress Tests

Results of EU-wide banks' stress tests were released late on Friday (23 July 2010) after the close of the European markets. Seven banks failed, of which five were from Spain, one was from Germany, and one from Greece.

The stress tests were conducted on a sample of 91 European Banks, which represented 65% (or €28,032 billion as of end of 2009) of the total assets of the 27-member EU banking sector as a whole. The tests also covered at least 50% of each EU member's national banking sector expressed in terms of total assets.

Failing the stress tests meant that these banks would be unable to maintain a critical Tier 1 capital ratio of 6% in the event of a recession and sovereign debt crisis. Going forward, these seven banks will shortly undergo restructuring and recapitalization plans, working closely with their national supervisors.

### Market reactions muted post-announcements

Before the stress tests results announcements, there was a slight sell-off in the markets.

As the European markets were closed, investors' sentiments and reactions to the stress tests results were reflected in the US markets. The Dow Jones Industrial Average dropped shortly after test results were announced around noon Eastern Daylight Time, but ended the day up 102 points, to 10,424.6. The U.S.-listed shares of some European Banks like Banco Santander SA and Banco Bilbao Vizcaya Argentaria SA strengthened into the release and were up on the day.

Generally, market reactions were muted, indicating that neither the worst fears nor greatest hopes were realized.

### Assessment of Results

There were some market criticisms about the European Banks stress test exercise. Market analysts suggested that the testing was not very rigorous and was set in such a way that most of them would pass the test. Many had expected at least 20 banks to miss the mark. They had also predicted that the total amount of capital required to raise the Tier 1 capital ratios to 6% would be in the range of €30 billion to €90 billion instead of the €3.5 billion at the end of the day.

Another major criticism against the European Banks stress test exercise is that it only assessed the potential losses on government bonds the banks trade, rather than those held in their banking book. That meant that the tests ignored majority of the banks' holdings of sovereign debt.

However, we believe that any stress test on the government's exposure in the banking books is unlikely to provide any new information that the market is not already aware of. It is well-known that the core European countries like Germany, France, Switzerland and Sweden are considerably exposed to the government bonds of the weaker peripheral countries. Therefore, a default in one of the heavily indebted peripheral countries will trigger a domino effect with disastrous results not only on Europe but also globally.



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In May this year, such fears put the Euro currency and the European financial markets under extraordinary pressure and threatened to break up the European Union. Since then, the EU governments have been strengthening its bailout infrastructure in an attempt to ring-fence the problem and to restore confidence in the markets.

We believe that the results of the stress tests are useful and should not be dismissed for the reasons below.

Firstly, the amount of disclosures has been impressive such as the detailed data on most banks' exposures to EU-27 sovereigns, on a country-by-country basis. This enables the market to estimate the capital needs of the European Banks using their own assumptions. Credit Suisse ran its own simulation exercise under more stringent assumptions such as a 5% Equity Tier One ratio standard and still found that the majority of the listed European banks passed the stress test.

Secondly, though the market questioned the credibility of the stress tests due a smaller than expected aggregate capital shortfall, we believe this low figure is partly due to the capital injection of €236 billion from the EU governments over the last 18 months. Additionally, there has been a significant improvement in the capital ratios by EU banks since last year due to retained earnings, balance sheet repair, de-leveraging, and new issuances.

Thirdly, the stress tests were robust enough to provide reassuring information about the ability to withstand a more severe economic scenario. The macroeconomic assumptions vary significantly across countries and tend to be severe for the more vulnerable economies. For example, in the case of Spain, the government used more stringent assumptions such as a decline in GDP of 2.6% during the 2010-2011 period after contracting by 3.6% in 2009. Nonetheless, the vast majority of the 27 Spanish institutions analysed passed the stress test with its two biggest banks, Banco Santander SA and Banco Bilbao Vizcaya Argentaria SA reporting 2011 Tier 1 capital ratios of 10.0% and 9.3% respectively under the Adverse Scenario after sovereign shock. Together, they account for 47.6% of the banking system's total assets. Hence we believe that data such as those coming out from Spain will help to allay concerns over the soundness of Spain's banking system.

Lastly, another benefit of the European Banks stress test is the closer cooperation within EU which represents a positive move towards reinforcing European unity.

### **Confidence seems to be slowly returning to Europe**

The Euro area sovereign/banking crisis appears to have turned a corner during the last few weeks as the market is becoming increasingly confident that the European Stabilisation Mechanism, ECB's responses, fiscal consolidation and reforms are putting Europe on a firmer platform to deal with the debt crisis. One case in point, Greece, Spain and Portugal managed to sell €50 billion of sovereign debt since May 2010 when the €750 billion rescue package was created.

The mixed results from the European Banks stress tests are not likely to distract the markets from this positive trend. While markets may be disappointed over the sovereign risk assumptions, the impressive data disclosures and the adverse scenarios simulations should help improve confidence in peripheral economies like Spain and Ireland.



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### Contact Details

**Address** 80 Raffles Place UOB Plaza 2 Level 3 Singapore 048624  
**24-hour Hotline** 1800 222 2228 (Local) • (65) 6222 2228 (International)  
**Fax** (65) 6532 3868  
**Email** uobam@uobgroup.com  
**Website** uobam.com.sg

### Regional Offices

#### Singapore

Institutional Investments  
Dennis Siew  
Senior Director

Retail Investments  
Norman Wu  
Senior Director

Regional Investments  
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