Bank stress tests: what top managers across Europe expect

By **Dalvinder Kular**, **Federico Simonelli**, **Terri-Ann Williams** / 29 Jul, 2016 at 09:01

Fifty one of Europe's biggest banks are being assessed by the European Banking Authority (EBA) and the results could expose weaknesses in lenders from across the region and provide a health check for the sector as a whole.

The findings, which will be published today (July 29), are unlike previous years in that they will not give a 'pass' or 'fail' rating, while the tests have been criticised for examining a smaller number of banks than previous years.

Commentators have argued this omissions means investors are unable to assess the health of the European banking system properly at a time when there is increased scrutiny.

Under particularly strong focus is the world's oldest bank Monte dei Paschi di Siena (MPS), which has already been bailed out twice and is in need of more capital. The Italian banking sector has come under criticism for the level of non-performing loans (NLPs) in the system.

Against this backdrop, *Citywire Selector* asked leading managers for their views on how the results of the stress tests would impact the market.

Time to test stability

Citywire AA-rated Anthony Smouha has 4.5% exposure to Lloyds in his GAM Star Opportunities fund, with 2.8% allocated to HSBC, which are two UK banks being examined under the stress tests. However, he has no holdings in Italian banks.

Each bank will have results which will come out and those will provide a way forward. There is the case of one specific bank in Italy where things clearly have to be done. There will be guidance on how to achieve that.

There will probably be some remarks on the stability of the banks and what needs to be done in the system. I would not expect to see anything shocking or surprising from these results, I think we already know about a lot of the things that will be identified.

The capital strengthening of the banks is a process which has been going on over many years. Following events earlier this year, the ECB is fully aware of moving too fast in this multi-year process, which could affect market sentiment.

Within the eurozone, there will be a continued movement towards this single supervisory mechanism, this single market. Within a number of years there will be a single system as opposed to disparate national systems, which is the way forward. At the end of the day one has to move towards this harmonisation and I think that will be a message of the stress test.

For all of the banks that we have in our core holdings, I don't see any issues. There may be specific recommendations for these banks, but on a top down basis I see it as "business as usual".

There is growth in Europe, but it is slow growth. There are old issues to be dealt with there, including issues of profitability. Clearly the lower rates on the one hand help to mitigate the financing of non-performing loans but affects profitability and the at interest margins that can be made. The authorities want to enhance the entire system and I think they will be focusing on the system, rather than individual banks, much more.

Reduced credibility

Graham Campbell, who manages the Saracen Global Income and Growth fund, thinks the health of the banking sector is vital to the ability of the economy to function and grow. Banks need to have the ability to lend to both individuals and businesses and cost-cutting measures could be on the cards.

Since the financial crises of 2007/8 the objective of banking sector regulation has been to write off bad loans, recapitalise the banks and to encourage lending to stimulate growth. At the same time, regulation has forced banks to rebuild their capital positions to ensure they are strong enough to withstand another financial shock. Combining these contradictory objectives has not been straightforward as many management teams have been either slow or unwilling to own up to past mistakes and write off bad debts.

There have been many stress tests in the UK and in European banks over the past eight years. The ability of many banks to pass them, when investors know they are weak, has massively reduced their credibility – see Italian banks. After Standard Chartered raised capital, UK banks are all perceived as relatively strong in a European context. However, in these post-Brexit vote uncertain times management and investors are more inclined to build the capital buffers than grow lending. Demand for loans is also fragile.

In addition, as banks borrow short and lend long, the impact of quantitative easing has distorted the normally upward sloping over time yield curve, making it hard for banks to maintain their net interest margin. This leaves cost-cutting as the best source of maintaining profitability. Expect to hear much more of this in the months ahead.

Methodology is muddled

Kris Atkinson is well diversified across European banks in the Fidelity Funds – Global Hybrids Bond fund, which he co-manages with Andrei Gorodilov. He believes his holdings, which include CoCos, are well capitalised and able to withstand the shocks simulated in the tests.

As in the past few years, the stress tests are likely to be a non-event. This has been partly due to lack of credibility which could be compounded further this year as there is no absolute 'pass' or 'fail' published for the individual banks.

Italian banks will be in focus but given the scrutiny their balance sheets have faced already, this is largely priced into the market. However, post the stress tests, the response to Italy's banking problems will be a key driver of markets.

Other names worth watching are Deutsche Bank, but again this is a story that the market knows well. As for other European banks, they have screened well previously and see no changes in their balance sheets or EBA methodology to suggest this time would be any different.

On the ground in Italy

Francesco Castelli, who is head of fixed income at Banor Capital, said these tests cover just five Italian banks compared to more than 10 being examined two years ago, which means the impact will be smaller.

The purpose of the stress test is mainly to influence the judgment on capital requirements that the ECB and the EBA will update in autumn. For Italy I expect that the difficulties of MSP on the NPL side and on government bonds will come out. Remember that the stress test assumes, by definition, a stress situation, then a slowdown of the economic cycle. In this context MPS can only emerge as a troubled bank.

The bank could already communicate a restructuring plan over the weekend. The problem is that MPS has already made a number of capital increases, and those who have participated in past increases will not participate in the next one. So, what are the solutions? The bad one is to convert the subordinated bonds in equity, but that would be very hard for retail subordinated bondholders, and could also have political impacts for the government.

The good one, which at the moment is more likely, is that the 'Atlas' backstop fund undertakes a significant portion of MPS net ‘sofferenze’, around €10 billion net. Then they will make a securitisation: around €3 billion of the mezzanine tranche, which is more risky, can go to Atlas, the rest can go to the market.

At that point MSP, all cleaned up, can make a capital increase without state help. But that works only if Atlas buys the NPLs at a slightly higher value than what the market would pay and if Europe somehow turns a blind eye on this. In terms of allocation: the European banking system is difficult to evaluate in terms of risk/return profile. Profits are very low. So we are underweight financial equity.

But there are also interesting opportunities: take Intesa Sanpaolo, which is clearly the right bank in the wrong place. They promise dividends of $ 3 billion in 2016 and $4 billion next year. And the bank trades at 65% book price. That means taking home excellent performances. We are willing to put our money here. We are a bit more constructive on credit. Subordinated debt of high-quality names seems pretty safe at the moment.