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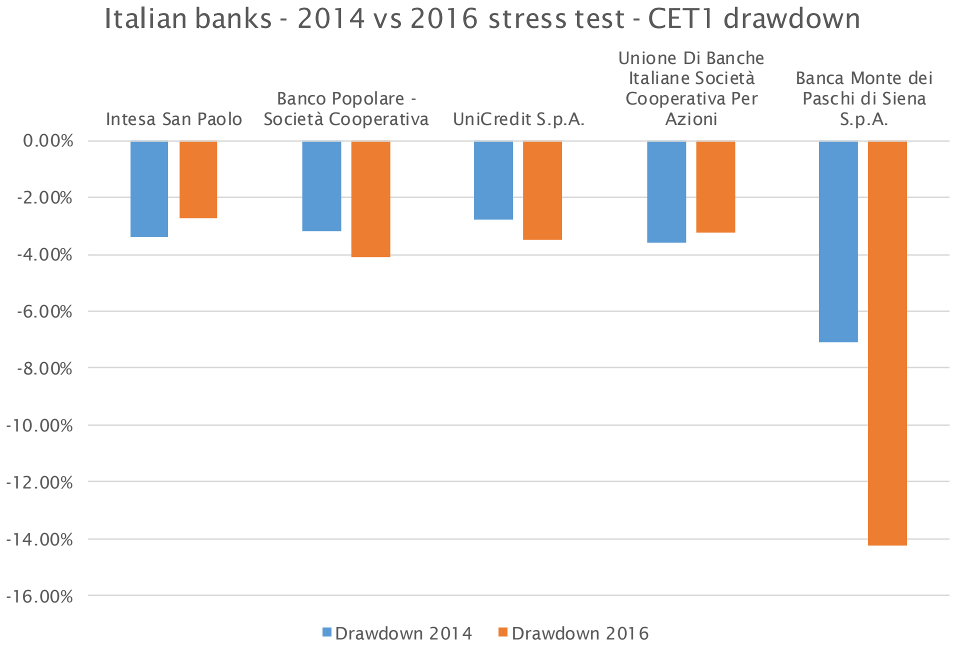
August 2nd, 2016

EBA Stress tests 2016: same elephant, same room

The results of the EBA stress tests were published late last Friday and were, we believe, largely within expectations. In this note, we will not analyze each bank but focus on the five main conclusions that we would draw from this soon-to-be yearly exercise: (i) what does it mean for Monte dei Paschi, (ii) are there significant individual surprises in the stress tests, (iii) what are the practical consequences for the banks involved, (iv) what are the practical consequences for the banks NOT involved and (v) how will these numbers impact future SREP ratios.

I. Monte dei Paschi: every good boy deserves fudge

As in 2014, the EBA stress tests have a huge elephant in the room and it is actually the same one, Monte dei Paschi, with a -2.2% CET1 ratio in the adverse scenario, the second worst being a world apart (RZB, 6.1%). In a way, this is not a surprise, since this poor outcome had been flagged in the press and MPS is hardly one of the best banks around. Still, the results are surprising: MPS failed the previous stress tests mostly due to massive AQR true-ups, has been heavily recapitalize since then (beyond what was requested), is profitable (the H1 results were actually much better than expected) and, last but not least, the macro scenario for Italy was less severe than in the 2014 stress tests. Unsurprisingly, most Italian banks performed decently, as illustrated below:



Of course, MPS is the weakest of the large Italian banks, but this was already true in 2014 – probably even truer back then. What happened?

There are five main drivers to a stress test outcome: net income ex loan losses and tax, loan losses ("LLP"), taxes, RWA inflation and mark to market of the bond portfolio. We would like to make the following points:

- **Contrary to popular "wisdom", asset quality at MPS has improved**: the adverse scenario has LLPs equal to -10.75% of RWAs vs. 12.3% in 2014 (and our estimate of -10.85%).
- The sovereign shock scenario has also improved with -1.31% of RWAs vs -1.8% in 2014 (and -1% in our estimates.)
- RWA inflation is slightly worse than expected, with credit RWA flat (vs. -8% in 2014 and -6% in our estimates) and increased RWAs for operational risk, something that was not modeled in the 2014 stress tests.

Globally, this would point to a more benign outcome for MPS – still we had a miserable fail. Why? Simply because the two remaining items had a **massive** impact:

- In 2014, the net interest income of MPS was flat in the adverse scenario – it is now modeled to be -54%! We find it extremely hard to believe that the funding profile of MPS has deteriorated that much (or even deteriorated at all), especially in a world where banks can raise cash at the TLTRO for -0.4% p.a. This huge difference in NII sensitivity is mostly explained by a new methodology that uses credit rating downgrades as another source of P&L volatility.

- In 2014, capital deductions from DTAs were limited. They now represent 3.2bn€, 450bps of CET1, despite the fact that the Italian law still allows for DTCs, i.e. DTAs that are not deducted from CET1. **This is due to a new assumption in the 2016 stress tests that taxation should be harmonized (including tax rates!)**

Hence, the 2016 stress tests show that by subtle changes in the methodologies it is possible to drastically impact the outcome of the stress tests, especially for banks with low credit ratings and high tax sensitivity. This is highly relevant since, as most investors in MPS are now aware, the BRRD allows for specific (i.e. more generous) treatments for public recapitalizations that are made in order to fill a shortfall identified by a stress test.
Analyzing the EBA transparency credit quality disclosure of MPS we had come to the conclusion that MPS was needing an extra 5bn€ of NPL coverage. This is now the number that the bank is willing to raise in order to compensate for the additional coverage required to sell a very large stock of NPLs to private investors. It is quite extraordinary that using the same metric as the 2014 stress test (i.e. 5.5% pass rate, which is the same as 5.5% + systemic risk buffer, as the latter is 0 for MPS) one identifies a CET1 5.4bn€ shortfall, almost exactly the amount that the bank needs to raise to sell its NPLs, at the ECB's request.

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II. Surprises, winners and losers

Apart from MPS, we find the results of these public stress tests rather underwhelming and believe they could very well be forgotten three months from now.

Generally speaking, the tests show that the sector is resilient with 370bps of profits compensated by 370bps of credit losses, the fall in CET1 ratio coming from market risk losses (-130bps but we find this very hard to model reliably), conduct risk (-110bps, something investors are unfortunately very familiar with), RWA inflation (-120bps, which is close to meaningless anyway with Basel 4 around the corner) and Basel 3 phasing (-50bps.) As always in a stress test, there is no real winner, except the banks no one will talk about (the Nordics).

From a pure mechanical point of view, the losers[1] (ex. MPS) appear to be the following banks:

- Low CET1 ratios under adverse scenario: RZB (6.1%), Banco Popular (7%), Unicredit (7.1%), Barclays (7.3%), AIB (7.4%) and Commerzbank (7.4%). These are all phased-in ratios, the only relevant ones for regulatory purposes.

- Low leverage ratios: ABN, Bylan, RZB, NDB, Commerzbank.

- Very large CET1 ratios drawdowns: AIB (-8.5%), RBS (-7.5%), LBBW (-6.9%), Bylan (-6.9%), Commerzbank (-6.4%) and Banco Popular (-6.1%)

- Very large leverage ratios drawdowns: AIB (-4.4%), RBS (-2.4%), OTP (-2.4%), Bank of Ireland (-2.1%) and Banco Popular (-2.0%)

However, we do not believe this will mean that the market will view these banks as "winners" or "losers" of the stress tests as these numbers (a) often depend on the starting point of the ratio or (b) are very similar to the outcome of the 2014 stress tests and will not surprise the market.

We now try to assess the actual losers by comparing the outcome (CET1 drawdown) with the 2014 stress tests and with our expectations. This allows us to draw the following conclusions.

Generally speaking, the 2016 stress tests were harsher, not because of more severe macroeconomic scenarios, but due to methodological changes that we believe were poorly understood by investors. These include:

- Modeling of conduct risk
- Harsher market risk scenarios
- Credit rating migration in NII modeling
- Uniform tax approach

This is why overall the CET1 drawdowns are worse than in 2014 (the unweighted average is -144bps worse).

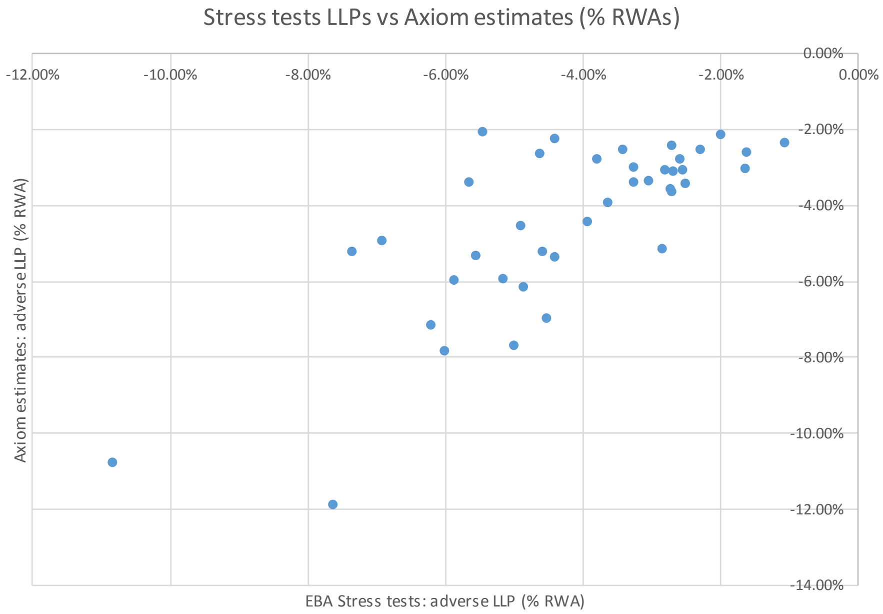
[1] We focus only on listed or « investable » banks and do not mention public (e.g. BNG) or captive (e.g. VW) banks

The banks that performed significantly worse than in 2014 (difference above 2%) are the following: MPS (see above), RBS (-4.54%), Bankia (-3.63%), Banco Popular (-3.6%), Commerzbank (-3.48%), NDB (-3.44%), Bank of Ireland (-3.09%), Bylan (-3.07%), ABN (-3.01%), Santander (-2.59%), ING (-2.5%), RZB (-2.38%), BBVA and Barclays (-2.17%).

However, the reasons for such differences (and sometimes for the differences with our expectations) vary greatly.

- Conduct risk is a new item that hit very severely RBS (we think[2] it was -380bps of CET1 gross of tax), but also Lloyds (-165bps) or Barclays (-190bps). We have an ambivalent view on this new item: the bad news is that regulators are finally looking at it and this will impair the outcome of future stress tests for these banks for many years to come but of course investors in these banks are more than aware that these costs exist and this will hardly be news to them.

- The chart below shows that our estimates of stress LLPs were fairly consistent with the final numbers.



Some banks performed poorly in the stress tests because they had higher LLPs compared to our estimates (which rely mostly on the changes in EBA macro scenarios). We believe this is a negative as it shows a deterioration in the credit quality of the books. This includes the following banks: BBVA, Bankia, Santander, Banco Popular, Barclays and NDB. We note that for some banks these problems have already been flagged and addressed: NDB with its shipping book and Banco Popular with its massive increase of provisions on foreclosed assets.

- Changes in RWA inflation was a major driver for a handful of banks: RBS had a +31 pp difference in RWA inflation from to 2014 to 2016 and this was one of the main reason for the

[2] Conduct risk is not explicitely flagged in the EBA template so this is our estimate.

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poor results. We believe this is linked to the deconsolidation of Citizens and to the sharp reduction in the share of the exposures that are under the more stable Standard Approach (as opposed to IRB.) Bank of Ireland was also strongly impacted (+14 pp) and we believe, paradoxically, that this is linked to the improvement of its books (high ratings are more sensitive to RWA inflation than NPLs and very low ratings.) Symmetrically, Deutsche Bank hugely benefited from reduced credit RWA inflation (-33 pp) and we need to investigate further the reason for this drastic change in sensitivity of the credit books of DB.

- Massive changes in NII sensitivity are also responsible for some of the negative surprises in these stress tests: apart from MPS discussed above, the banks impacted are German (NDB -20 pp, NRW -29 pp, LBBW -14.8 pp or Dekabank -78 pp, each time compared to the 2014 tests.) True, the 2014 stress tests did not offer a consistent modeling of NII sensitivity as sovereign spreads were viewed as the main driver, which obviously benefited German banks. Many banks had a 0 NII sensitivity. Still, the new methodology seems too harsh and probably does not fully account for the use of ECB funding, especially in times of stress, and independently of the credit rating of the bank (as long as collateral is available.)

- Last but not least, tax has hit some banks in a disproportionate way: those countries where the tax rate is very low (Ireland) had their operating profit "taxed" at a higher rate and those countries that have high usage of DTCs (Italy) were penalized because DTC were not recognized in the stress tests and DTAs were largely phased out by 2018.

Taking all these elements into account we would identify three types of "true losers" in these stress tests:

- The **asset quality losers** where the tests probably show some unexpected drop in the resilience of the credit books - e.g. NDB, Banco Popular or Sabadell. In some cases, these weaknesses have already been addressed. An outlier here seems to be Banco Popolare where we had expected much weaker results and we believe the ECB might have already taken into account the benefits of the merger with Popolare de Milano and coverage improvement.

- The **conduct risk losers**: we have not learned anything new and obviously the banks involved are well identified, but knowing that the EBA and the ECB will take it into account in the future and having an estimate of the impact is useful.

- **The NII losers**: some funding models (especially in Germany) have been challenged in the stress tests and we view this as positive since the previous tests could be viewed as slightly naïve or biased. However, we remain skeptical and still believe that this approach does not fully represent the reality of stressed NII for Eurozone banks in the context of easy ECB money and negative rates.

The rest of the differences between the 2014 and 2016 vintages of the stress tests seem to us mostly methodological and do not reflect, we believe, true economic changes.

III. Now what?

Clearly these stress tests lacked the cathartic drama of the 2014 tests. In practical terms, such tests are only relevant for investors when they trigger supervisory intervention or a shift in the business plan of a bank. Can we expect such events in the following months?

- MPS has already submitted (and received an approval for) a comprehensive recapitalization and NPL cleanup plan. Execution risk remains high but we believe the plan is credible and includes some very smart components (including the spin-off of the equity piece of the NPLs.) We will not discuss the plan in detail here but we note that the timing will be linked to the timing of the referendum which remains uncertain.

- RZB is also in the process of submitting a reorganization plan likely to include a merger of RZB and RBI and improved capital ratios (partly due to a better treatment of minority interests.)

- Unicredit will soon publish a new business plan, has sold some non-strategic stakes during the very first days in office of its new CEO and is widely expected to raise equity.

- NDB has announced an increase in coverage of its NPLs and a recapitalization of its subsidiary Bremer Landesbank (details remain unclear.)

- Banco Popular has announced a massive increase in coverage and a capital increase.

We think the other "weaker" (in stress tests terms) banks (Barclays, Commerzbank, AIB, ABN) are unlikely to announce any change in their business plan – setting aside the privatization of AIB, probably scheduled for 2017.
In this respect, the 2016 stress tests are very much like the previous ones: banks have largely anticipated the outcome or identified the issues themselves and are already taking measures to address their weaknesses.

IV. What matters is what you do not see

Perhaps, more important than the public stress tests were the non-public stress tests. Indeed, some of the most closely watched banks in Europe were not included in this round of public stress tests, including the large Portuguese banks (BCP, Novo Banco, Caixa Geral de Depositos), an Irish bank (Permanent TSB) or some smaller Spanish and Italian banks. Some uncertainty was still prevailing on two key questions:

- Were the other SSM banks still subject to a round of stress tests, albeit private ones?
- Would these stress tests eventually be published?

The answers were quick to come as BCP published its "stress test results", without the assurance that these results had been validated by the ECB. Still, we think this publication comforts our view that the SSM has at its disposal the stress test outcomes of all the banks under its supervision and that in most cases these results could eventually be published at some point, due to investor pressure for more transparency or for political reasons.

Our internal simulations, the differences with the published numbers and the few "private stress tests" that were published provide some guidance on the possible impacts for these banks.

- Mediobanca confirmed that the performance of Italian banks – MPS aside – was similar to 2014. The phase in ratio (only information available) dropped 0.94% vs. 2.2% in 2014.

- The performance of BCP is much more important due to the challenging situation of the Portuguese banking sector, the current request for state aid repayment and the poor asset quality profile. In 2014 the Portuguese bank had a 7.3% drawdown vs. 6.1% in the 2016 exercise. The final CET1 is 7.2% and we had estimated 8.1% so we view the number as slightly worse than expected but reasonably good compared to 2014.

Taking this into consideration, we would flag the following banks that could be next in line to raise equity following a negative private stress test result:

- Banco Mare Nostrum had a decent 2014 stress test number but this was largely supported by DTCs and by a very stable NII in the adverse scenario, both unlikely to be sustained. The stress test could trigger further M&A in Spain.

- Caixa Geral had a 4.3% drawdown in 2014 but with the 3y-forward adverse NII 45% above the realized 2013 NII and almost 20% above the 2015 realized NII… We think a failed stress test could provide for an additional argument supporting the Portuguese government's view that it should be allowed to recapitalize Caixa Geral without a bail-in.

- Banca Carige could fail a private stress test and justify a capital plan designed to improve its coverage ratio (the methodology we used on MPS to calculate a 5bn€ shortfall yields a 680M€ shortfall for Carige.)

- Consistent with the poor results of other Irish banks (and largely due to methodological choices) we think Permanent TSB could perform poorly in the private stress test.

- We also think that Liberbank, for a variety of reasons (including asset quality and the end of the APS but also possibly a negative stress test outcome), could need to raise equity.

V. <u>How will these numbers impact future SREP ratios?</u>

It has been widely reported that the stress test will be one of the component used to compute the so-called Pillar 2 guidance, i.e. the part of the Pillar 2 "requirement" which will not actually be a requirement and will not impact distribution capacity and MDA limitations (although we expect that banks below their Pillar 2 guidance will struggle to pay a cash dividend.) Generally speaking, two questions need to be properly distinguished:

- Will the stress test change the total Pillar 2 (requirement + guidance)? The SSM heads have clearly and repeatedly stated that the stress tests would not bring substantial additional information to the supervisor (which seems logical). This is why, generally speaking, total SREP ratios are not expected to change. We believe the only cases where changes can be expected are when (i) there is a substantial difference with the 2014 stress tests and this difference is not explained by methodological differences and has not already been addressed by the bank or (ii) when the stress test outcome brings the bank substantially below its requirement (pillar 1 + 2 under the adverse scenario or pillar 1 + 2 + CBR under the baseline scenario.)

- How will the stress test impact the pillar 2 split between requirement and guidance – a key question for AT1 investors. Although the immediate intuition is that a poor stress test result should lead to higher requirements, we believe the exact opposite could be true: indeed, as explained by the EC, a stress test is a hypothetical exercise and as such should be covered by a guidance. Hence, the poorer the stress test outcome, the higher the total Pillar 2, but also the higher the share of that total Pillar 2 that should be defined as a guidance as opposed to a requirement (taking into account the CBR.) Estimating these numbers will be crucial for fixed income investors when the Pillar 2 requirements will be published, probably in Q4.