

European & United States bank stress tests fundamentally different, says RCM

- **US and European bank stress tests were fundamentally different**
- **Economic growth is necessary to reinforce the capital base of banks**
- **Only overnight lending and refinancing of bonds is likely to indicate the true health of the banking systems**
- **The softening of Basel III recommendations is a concern for the future**

Neil Dwane, Chief Investment Officer (CIO) Europe at RCM reflects on the outlook for the banking sector in Europe now that the dust has settled after the European stress tests and with the loosening of Basel III regulations*.

Neil Dwane, CIO Europe at RCM comments:

“The US and European bank stress tests were fundamentally different in character. The US stress tests were less of a test and more of a forced recapitalisation of the banking industry, which led to a 35% rally in banking stocks in the US [source RCM]. However, once this was carried out in America, Europe had to carry out the tests in order to reassure the markets.

“In Europe, things were different. Not only did markets and banking stocks rally in advance of the tests, but, they were also never about a forced recapitalisation of the major banks. Furthermore, the possibility that Greece might default, and the effect of that on European banks, was taken out of the equation. Indeed the European stress tests revealed, more than anything, just how badly the European banking sector needs stronger economic growth to enable it to recapitalise and stabilise in the long term.

“Therefore in my opinion, both tests were genuinely different in character and the results from the US and Europe are not comparable in determining the health of the banking industry in these markets.

“In my view, the underlying problems have not been solved in Europe. While it is not surprising that the market has rallied, we still have an economy and banking sector which are vulnerable to economic slowdown or financial infection.

“Prudent management within the banks would seek to raise banking capital in recovering markets, but at this point in time, due to a variety of political and corporate influences, we seem to have ended up with a policy through the Basel III rules that has forgotten the causes and severity of the financial crisis in 2008. By not making any major changes in policy, I believe that we are increasing the risk that the crisis will be repeated in the future.

The need for economic growth

“The key premise coming out of the European tests is the real need for economic growth to allow European banks to raise capital going forward through profits, and therefore repair their balance sheets. If this turns out to be the case, then European banks are indeed not "stressed". Should, however, the planned austerity package depress or delay economic recovery, producing a possible double dip scenario, then clearly the European banks may well become "stressed" within such an environment.

Realtime indicators of accuracy and credibility of stress test results

“Looking to the future, in my opinion, there are two signs which investors can easily follow, which are likely to reveal to what extent the stress tests results were in fact correct and credible. The first sign is the rate at which banks are prepared to lend to each other. In times of stress, as has been seen in the past, the cost of lending has soared as banks do not trust their counterparties. If the stress tests were real, then we should see the banks which have passed the tests be recognised as sound by their counterparts, and therefore see the cost of intrabank lending come down in the weeks and months ahead, indicating that the banks believe the results of this test themselves.

“Secondly, the banking sector has an additional issue, in the form of re-financing their financial bonds. About 1 trillion Euro of assets exists in the European bond market, which directly supports the asset base of the European banks, and much of which needs to be rolled over in the next 18 months. The rolling over of these bonds is likely to be another key indicator of just how much the market trusts the European banks to be "stress-free" in reality.

“In my view, the key will be to pay close attention to bank bonds as they are rolled over. For the banks that have passed the stress tests, this should be smooth and at competitive interest rates. This could be an important gauge on the health of the financial sector going forward, because if banks cannot access finance or re-finance themselves in the bond, or covered bond market, they will be forced to rely on funding from the European Central Bank instead, or see their capitalisation levels drop even further.

The softening of Basel III requirements

“Many market participants have been waiting for renewed and more rigorous rules to come from Basel to correct the previous wrongs and the credit arbitrage seen in the 2008 financial crisis. However, the new Basel III recommendations have been significantly watered down. This means that, either the banking lobby has remained strong enough to influence at a political level to soften regulations, or deeper analysis of the banking sector made it clear that it is not currently robust enough to cope with the appropriate regulation needed to avoid a similar financial crisis occurring in the future.

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Notes to Editors

* The Basel Committee, established by the central-bank Governors of the Group of Ten countries at the end of 1974, meets regularly four times a year. It has four main working groups which also meet regularly (*Source: Bank of International Settlements*)

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- RCM Highly Commended for Equities Manager of the Year, at the European Pensions awards 2010.
- RCM named winner of Active North American Equity at Pensions & Investment Provider awards 2009. RCM US Large Cap Select Growth is managed by Scott Migliori, CIO for US Equities, RCM.
- RCM named No.1 leading fund management firm for SRI Research by Thomson Reuters Extel 2009.
- Global CIO of RCM, Andreas Utermann, named CIO of the Year by Funds Europe magazine 2008.
- Winner of European Investment Trust of the Year by Investment Week magazine, 2008, for the RCM-managed Charter European Trust.
- Allianz RCM Global EcoTrends Fund named winner Best Climate Change Investment fund 2008, by Holden & Partners/ Incisive Media.

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