Topics: A note from the European Banking Authority

As per the note below, the European Banking Authority (EBA) holds the global investment community hostage by insisting that EU banks, in their entirety, only need another 3 billion Euros in capital. The markets do not believe this, or we would not be seeing wholesale deposit flight from EU banks by US money market funds (see Appendix chart), a shutdown in unsecured EU bank debt markets, and rising pressure on the ECB to finance European banks (Spain and Italy have been very active borrowers recently). According to the Institute of International Finance, European banks have raised 320 billion Euros in capital since 2008, but the EBA's view of capital sufficiency is in the minority. Most sell side research estimates of EU bank capital shortfalls are 10x-20x higher than the EBA's estimate; buy side estimates we have seen are 40x-50x higher. The IMF mentioned 200 billion Euros, but IMF Director Lagarde appears to have backed down from this due to the controversy it created (she now says such estimates were "tentative"). She has good company, however: the German economic institute DIW, in an interview with *Frankfurt Allgemeine Sonntagszeitung*, believes German banks *alone* need 127 billion in capital.

AtTenTiON iNternaTiOnAl
iNVestmenT CommunitY!!!

We DOnOt THiNk oUr EuRopeAn
baNkS neEd a lOt moRE eQuIty
cApiTAl siNCe tHeY hAvE aLot

We alReady rAN sOMe StrEss
TEsTs aND tHe TOTal CaPitAL
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Our demAnds: If yOu disagreE
With us then dEPOsit 150 BN
Euros in a brown pAPer bag,
care of EBA, 25 OLD Broad St
LoNDOn EC2N 1HQ. OtherwIse
We will kEep igNORIng YOu

Before getting to what the markets may be waiting/hoping for, here are some things to know about EBA stress tests:

1. **Only sovereign debt held in bank *trading* books was assumed to bear loss, and not the same bonds held in the bank's *investment* account.** This assumption has had negative reverberations for markets, perhaps since it makes little sense to investors like us. For most EU banks, investment account holdings of sovereign debt exceed trading book holdings.
2. The **losses assumed** by the EBA on sovereign debt were 15% for Greece, 2% for Portugal, 1% for Ireland, and 0.3% each for Italy and Spain. Hope springs eternal; these numbers look low for purposes of a stress test, and given that massive debt forgiveness for Greece is practically a certainty at this point.

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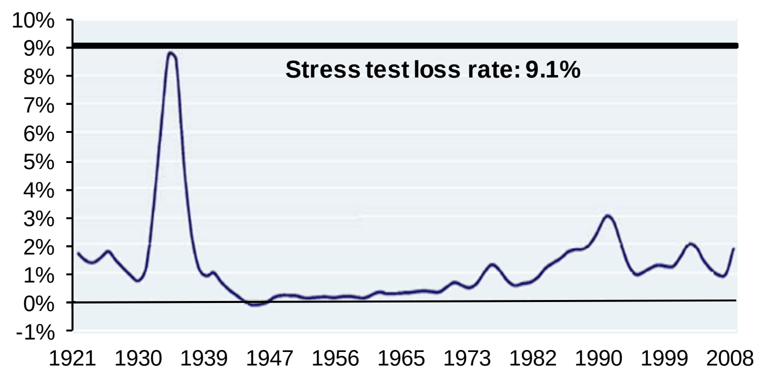
3. **Private sector losses look too low for purposes of a stress test, particularly if sovereign debt restructuring is assumed.** One example: Spain had perhaps the biggest housing bubble in the world outside Ireland[1]. EBA loan loss assumptions for Spanish mortgages are only 1.5% under the EBA “adverse scenario”. Residential mortgages are full-recourse in Spain, are generally on first homes and not vacation homes, and mostly pegged very low floating rates; as a result, current NPLs are only 2.5%. But with Spanish housing transactions down 70% from 2007, shouldn’t a stress test pencil in something worse? During Spain’s 1993 recession, when GDP growth also fell to 1%, problem loans reached 6.5% and loan loss provisions were 4.5%. In general, we find that most EBA assumptions are much less dire than May 2009 US stress test levels.
4. **The losses assumed by the EBA were offset by an almost identical amount of pre-provision income**, resulting in no capital shortfall for most banks. The income projections look high to us given economic conditions in Europe.
5. There’s a lot of confusion about which capital ratios make the most sense (Basel II, Basel III, Core Tier I, Equity to Assets, etc). **The EBA used the most generous one (Basel II).** These issues are complex, and are strenuously debated by investors. Our view: even after adjusting for differences in derivatives accounting (European banks hold more of their derivatives on balance-sheet), European banks report *much* lower risk-weighted assets as a % of total assets than US banks (see chart in Appendix). This may reflect the use of less conservative risk-weighting models in Europe; in the US, the Fed is quite strict on this issue. **In our view, there has not been enough detailed cross-border analysis to support permanently lower equity-to-asset ratios of European banks, regardless of what Basel III capital formulas say**.
6. The EBA stress test included a clause (“Point 15”) which stated a desire to reduce reliance on external rating agencies, and instructed the Commission to work on proposals to that effect. Rating-agency bashing is a worldwide sport these days, and they deserve it given their abjectly poor work on structured credit. But rating agencies have a better track record on corporate, sovereign and municipal exposure, and **this kind of comment is worrisome to investors when used cynically by politicians to refute ratings downgrades and risk assessments.** The same holds for criticism of S&P by the Secretary of the Treasury and members of Congress in the wake of the downgrade of the United States.

This is why financial markets have lost confidence in this process. Once lost, confidence is difficult to restore, and Europe is paying a price for this. Last year, share prices were high enough that perhaps EU banks could have raised equity at higher levels. As things stand now, with EU banks trading at close to 0.4 times book value, equity raises imply much more dilution for shareholders, and official sector capital may be the only way out for some.

The U.S. has plenty of problems regarding some of its own banks, but its 2009 stress test effectively convinced global markets to start dealing with US banks on a “business as usual” basis again. As shown in the chart, the Supervisory Capital Assessment Program (SCAP) used loss assumptions that rivaled the peak of the Great Depression. The purpose was to move beyond bank solvency as a systemic market risk issue, and focus on other things.

US stress tests: loss rates set at Depression levels
Percent



Source: IMF(1920-1933), Federal Deposit Insurance Corporation (1934-2007), commercial bank reports on condition and income (2008).

Until the issue of European bank capitalization is addressed, it will be difficult for global markets to regain their footing, despite what looks like oversold conditions in equity markets. We expect the EU to address this, perhaps by converting the EFSF into a government-owned bank which would buy government-issued bonds using debt financing from the government-run Central Bank (I know, the government is sitting in all the seats; don’t ask). Commissioner for Economic and Financial Affairs Olli Rehn acknowledged that the EFSF’s firepower needs to be increased, and EFSF CEO Klaus Regling responded to questions on the topic by saying “wait a few more days”. Our sources tell us something is in the works. However, the timing, magnitude and realism of the official sector response will determine how positive the market reaction will be. Seeing is believing.

Michael Cembalest
Chief Investment Officer

[see Appendix for some charts on European banks]

[1] Peak home price to income ratios: Ireland 12.0x, Spain 8.0x, US 4.5x.

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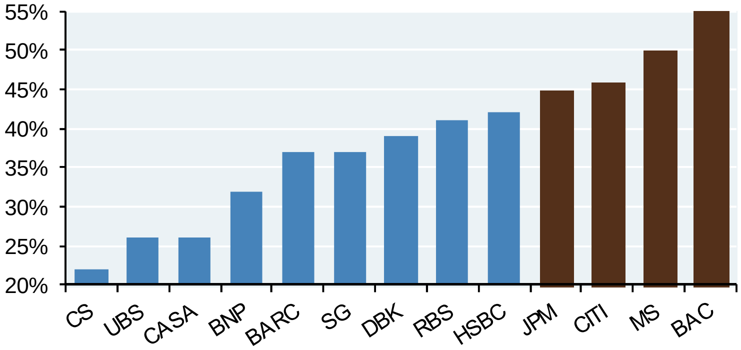
Appendix: European banks: bigger, badder and now, cheaper

As shown in the first chart, European banks claim to carry less risk than US banks, so they carry less capital as a % of total assets. However, many institutional investors do not believe this, which is why price/book ratios are plummeting, and why European assets as a % of US money market fund assets are falling. European banks are bigger than US counterparts; the world is waiting for the European Financial Stability Fund to start recapitalizing them. Unlimited ECB financing is not enough.

How much risk do banks claim they have?
Risk-weighted assets as a percentage of total assets

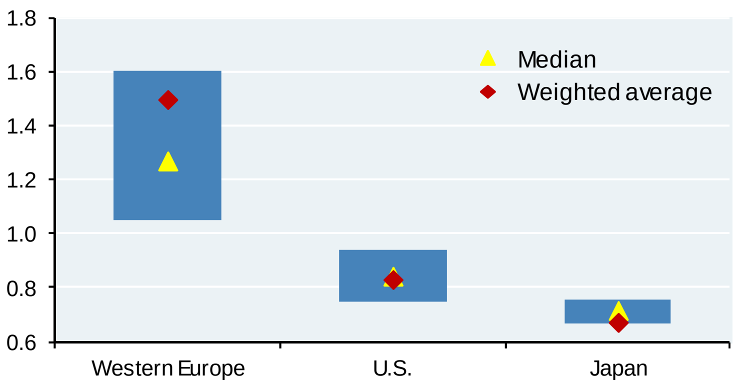


Source: Goldman Sachs. Data as of May 2011.
Includes off balance sheet items and derivatives for all banks.

EuroStoxx Banks Index: reality finally sets in
Price-to-book ratio

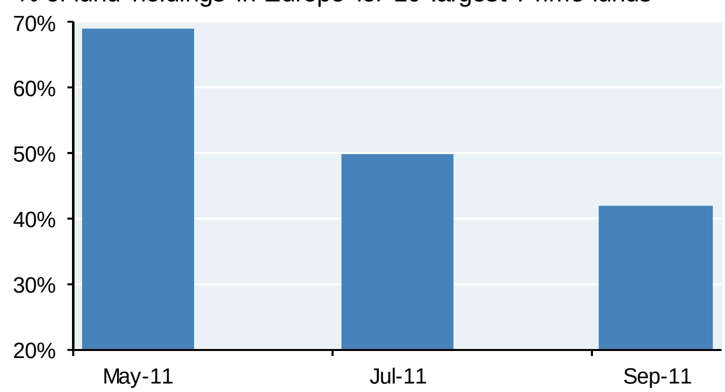
Source: Bloomberg.

G-3 banking sector loan to deposit ratios
Ratio



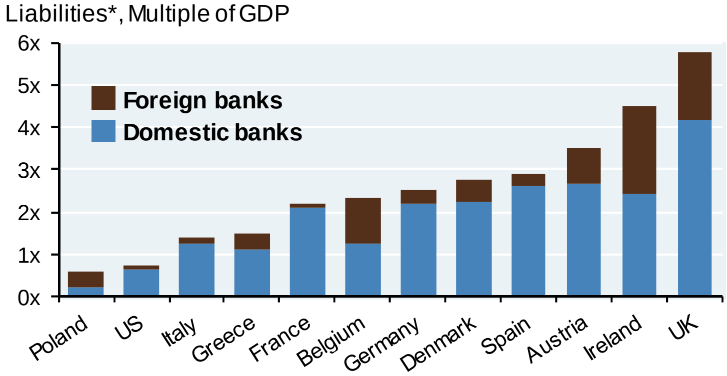
Source: J.P. Morgan Securities LLC, Bloomberg.

US money market funds' exposure to European banks
% of fund holdings in Europe for 10 largest Prime funds



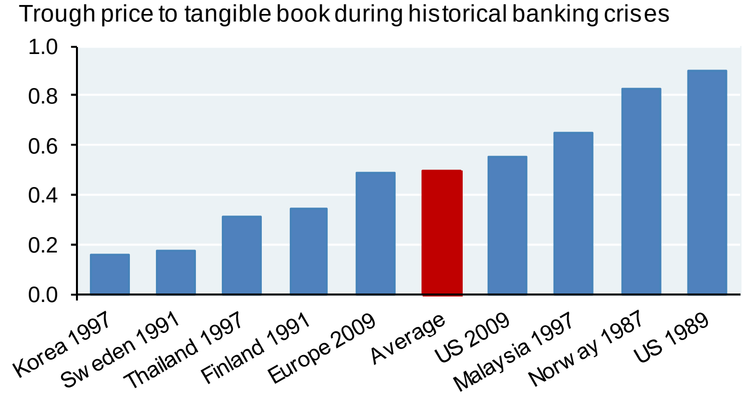
Source: Fitch Ratings.

Europe: bigger banks, bigger problems
Liabilities*, Multiple of GDP



Source: Federal Reserve, ECB, J.P. Morgan Private Bank. Data as of 2Q10.
*Select liabilities include deposits and other debt securities.

How bad can banks get in a crisis?
Trough price to tangible book during historical banking crises



Source: Estimates based on Thomson Reuters, Credit Suisse HOLT, Credit Suisse research

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NPL = Non-performing loan
ECB = European Central Bank
EFSF = European Financial Stability Facility