Markit Recap – 10/27/2014

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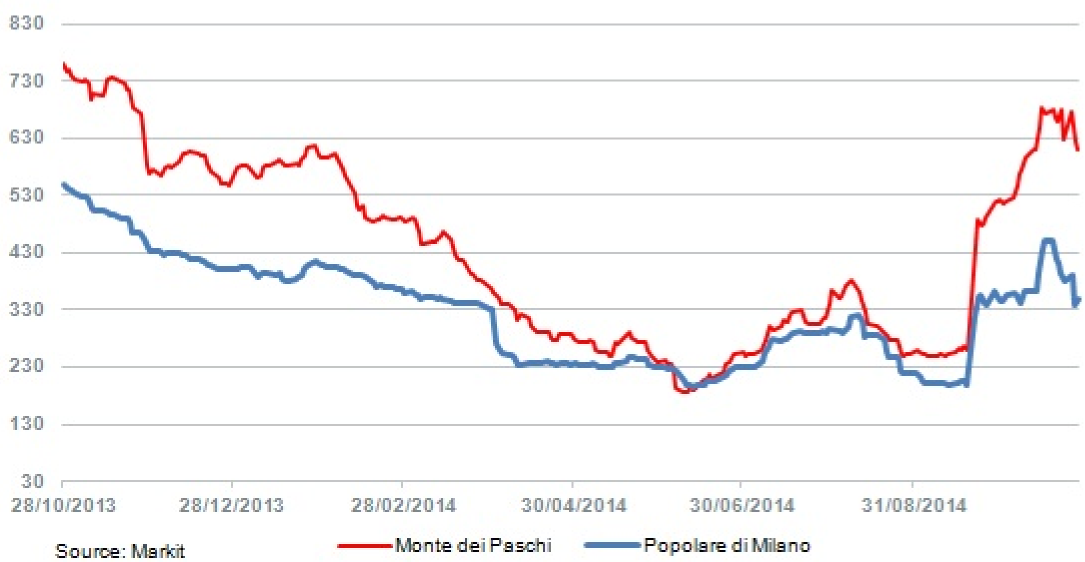
Earnings season is well underway and the Federal Reserve is set to end its bond purchase programme, but in Europe all eyes were on the results of the ECB's asset quality review and stress tests.

A total of 25 banks out of 130 failed the tests, though only 13 banks have capital shortfalls once prudential actions this year are taken into account. Overall, the eurozone's banks need to find €9.5bn (approximately 0.1% of eurozone GDP) to fill the capital hole.



Italian bank Monte dei Paschi emerged as the biggest failure, with a capital shortfall of €2.11bn. A look at the company's CDS spreads shows that this was no great surprise to the credit markets. Prior to the introduction of ISDA 2014 definitions on September 22, the subordinated 5-year spread was trading at 260bps. It then widened sharply due to the new definitions increasing the value of subordinated CDS protection (the changes affected all European banks). But Monte dei Paschi's spreads continued to widen in the following weeks and underperformed European peers. On the eve of the stress test results, they were trading at 627bps, 185bps wider than the September 22 levels.

After the announcement of the results, Monte's sub spreads gave up a further 50bps to trade at 677bps. But only two days later they had recovered to 610bps, an improvement from the pre-result levels. On the face of it, this seems surprising given that subordinated bondholders are in the firing line if government intervention forces a bail-in (an eventuality that the new definitions explicitly cover through an additional credit event). But the Italian authorities were quick to deny that public money would be used to prop up the country's ailing banking sector (three other institutions require capital injections). The market reaction indicates that the denial is credible, at least for now.

Monte dei Paschi has already received €4bn in public aid, some of which has been paid back, and other alternatives are likely to be considered before that route is taken again. It can sell assets or raise funds through a rights issue, both of which should be positive for credit investors. Or it could sell itself to another, larger institution, which would also benefit bondholders. But the still elevated level of its spreads shows that there is considerable credit risk attached to the world's oldest bank.

The dust is still settling from the results, but it seems clear that the catharsis EU officials hoped for hasn't materialised. The AQR, in particular, was worthwhile and bank balance sheets are more transparent. But it doesn't follow that Europe's banks will now embark on a lending spree – lack of demand remains the underlying problem. Deflation looms, a scenario, incidentally, that the stress tests didn't consider.

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