

## **The Upcoming ECB Stress Tests**

More than a year has passed since the decisions taken by the Eurogroup for our banking sector that led to a massive loss of confidence among investors and depositors (domestic and foreign). Since March 2013, a number of steps have been taken to restore confidence that included re-capitalisation and partial restructuring of the three main banking institutions (Bank of Cyprus, Hellenic Bank, and the Cooperative Society). The main and pressing issues that need to be resolved now, as the banks' executives had stressed repeatedly in recent times, have to do with the handling of their non-performing loans (NPLs) as well as their capital adequacy (the two issues are obviously linked), in light of the upcoming stress tests from the European Central Bank (ECB).

So, what is the process and purpose of these stress tests and why are they so important? The European Central Bank (ECB) is preparing to take on new banking supervision tasks as part of a Single Supervisory Mechanism (SSM), conceived as being able to – through consistency and integration – restore confidence in the supervision of all systemic banks in the Eurozone. This will begin from November 2014. Thus, 124 EU systemic banks will go through these so-called stress tests as a precaution. The idea is to ensure that the banks are well-capitalised, and can sustain themselves through adverse conditions if these occur in the future.

The process is two-fold: there will be an asset quality review, looking at balance sheets, and correcting them; and the 'stress' test itself, whereby the bank will be given a hypothetical scenario and have to prove that it could sustain itself under these adverse conditions. The base scenario that has been proposed more or less correlates with the macroeconomic outlook predicted by the Troika of international lenders for Cyprus, while the adverse scenario is worse and assumes a greater level of recession, unemployment, as well as fall in the value of real estate (collateral) in the coming years. The banks will be given six months to find the necessary capital if needed for the base scenario (need a minimum capital ratio of 8%), and nine months for the adverse scenario (need a minimum capital ratio of 5.5%).

Some market participants have criticized the stress tests as being too strict. My view on that is that the goal must be to create resilient banks, so that depositors and investors feel secure again. Stability will inspire trust, and this is imperative, especially with what has happened recently in Cyprus as well as to many other banks around the world. In the past, such stress tests might not have been that strict, and there were instances where banks would pass even though they weren't, in practical terms, resilient enough. As a consequence, they ended up needing capital in a relatively short period of time after the tests. Banks, unable to find the necessary capital from private investors, they ended up becoming nationalized (because they were "too big to fail"), or worse, in the case of Cyprus the decision was to convert uninsured deposits into capital (because the banks were "too big to save"! ). The stricter the test, the more confidence will be inspired; consequently, there's more chance of investors and depositors becoming active again.

The Bank of Cyprus, Hellenic and the Cooperative Central Banks – the three banks undergoing the stress tests – have all recently been re-capitalised; Bank of Cyprus through the participation of their existing shareholders, holders of bonds, and the uninsured depositors; Hellenic bank has been through private investors, while the Cooperative Central Bank through government funds. If they still need capital, there is an extra €1 billion from the Memorandum of Understanding (MoU) signed with the Troika set aside for the purpose of being allocated to the re-capitalisation of banks, as well as sources of capital from private investors. If we look at what happened recently with the successful recapitalisation of Greek banks (as well as a number of other banks in Europe), there is optimism that our own banks can source the necessary capital (if needed). There is an “appetite” for risk these days from funds abroad, as the interest rates across the globe are extremely low and are looking for investments that would provide them with higher returns (although these investments can come with higher risk). Furthermore, because of the quantitative easing programmes (QE) that have been going for some time now (especially in the US), there is ample liquidity these days in financial markets and investors are looking into the peripheral countries of Europe to invest. The banks are even considering increasing their capital adequacy in the very near future, ahead of the stress tests. It’s probably a wise move, given the appetite for investment that exists in global markets.

Overall, these tests are very important and if our banks end up successfully passing them will be a massive injection of confidence to the system.