

## Results of the EU-wide stress test for Germany

- **German banks prove to be robust and resilient**
- **Average tier 1 capital ratio of the German banking system up by almost 2 percentage points in the last three years**
- **Solvency assured, with tier 1 capital ratio just over 8.9%, even given sharp decline in growth and shifts in the yield curve**
- **In addition, German banks cope very well with the simulated drop in government bonds prices paired with rise in risk premiums, tier 1 capital ratio in this scenario 8.5%**
- **HRE is the only German bank to fall short of the 6% tier 1 capital ratio in the most severe stress scenario**

On 17 June 2010, the heads of state or government of the European Union resolved to publish results of the EU-wide stress tests carried out by the Committee of European Banking Supervisors (CEBS) in cooperation with the national supervisory authorities and the ECB. The objective of the stress test exercise is to make transparent the resilience of the European banking system in the event of an economic downturn and of negative financial market developments (in particular, a drop in the value of European government bonds).

At the same time, the number of tested countries and banks compared with the first ever stress test conducted at CEBS level last year was increased considerably. A total of 91 credit institutions from 20 member countries took part in this EU-wide stress test exercise, representing 65% of the EU banking

system in terms of total assets (link to CEBS website: <http://www.cebs.org/News--Communications/Latest-news/CEBS-statement-on-key-features-of-the-extended-EU-.aspx>). The 14 participating banks from Germany represent more than 60% of the total assets of the German banking system – including UniCredit Bank AG, which participated in the consolidated stress test of its Italian parent.

It must be borne in mind that stress tests constitute only hypothetical (“what if”) analyses of negative developments. As such, they must not be confused with forecasts of future capital requirements. Similarly, the markets' expectation that the banks – differentiated by business structure – show higher tier 1 capital ratios than those called for under regulatory requirements refer to the banks' actual tier 1 capital base and not to the imputed capital ratios calculated according to the stress tests.

### Scenarios

In conducting the EU-wide stress test, a distinction is made between a benchmark scenario and two stress scenarios.

The macroeconomic benchmark scenario is based on the European Commission's spring economic forecasts for 2010 and 2011, which was overly pessimistic from today's point of view, covering areas such as gross domestic product, unemployment and housing prices. By contrast, the current Bundesbank and ECB projections paint a picture of economic developments for 2010 which is clearly more positive than the benchmark scenario used in the EU stress tests.

Amongst other things, the EU stress scenarios assume a slowdown in euro-area economic activity for 2010 and 2011 by a cumulative 3.0 percentage points, with German economic activity to drop by as much as 3.3 percentage points (measured as the deviation from the benchmark scenario). This

restrictive assumption on which the EU stress tests are based is further highlighted by the fact that the stress scenarios assume negative growth rates for the euro area as a whole in both years and for Germany in 2011. This constitutes a double dip scenario, which is highly unlikely as things stand at present.

Moreover, in the first stress scenario a distinct increase in the yield curve with a simultaneous flattening is assumed. A marked deterioration of four credit rating notches, cumulated over two years, was simulated for securitisations. In a supplementary stress scenario, a rise in risk premiums for European government bonds is assumed. The simulated spread increases go beyond the considerable hikes witnessed at the beginning of May 2010.

Please see CEBS website (link: <http://www.c-ebs.org>) and ECB website (link: <http://www.ecb.int>) for more details on the scenarios and parameters.

On the whole, the assumptions for the macroeconomic shock in the EU stress scenarios are more severe than those used in the stress tests conducted in the USA in the first half-year of 2009. In the US stress test exercise, the aggregate deviation of economic growth rates from the expected basic economic path for the years 2009 and 2010 was 2.9 percentage points. Under the EU stress tests, moreover, all participating banks had to take into consideration not only the effects of financial market upheavals on their trading book but also the consequences of rising risk premiums on European government bonds. In contrast, for the US stress test only five banks which were particularly active in trading had to additionally factor in trading book losses.

## Results

A credit institution is deemed to have passed the test if its tier 1 capital ratio does not drop below 6% even in the most severe stress scenario. Measured

by this criterion, the German banking system has shown itself to be robust and proved its resilience even under very pessimistic assumptions. Even in the extreme scenario, 13 of the 14 banks show a tier 1 capital ratio of more than 6%; nine of the participating banks post a tier 1 capital ratio of more than 8% in this particularly severe stress scenario, which is more than twice the regulatory minimum.

The average tier 1 capital ratio<sup>1</sup> of the 14 participating banks at end-2011 according to the first stress scenario is 8.9%, and 8.5% when the rise in risk premiums on European government bonds is also included. This constitutes a decline of 1.6 and 2.0 percentage points respectively compared with the end of 2009 (see annex for individual results).

One of the main reasons for the robust performance is that tier 1 capital has already been strengthened. Over the last two years, the German banks have undertaken considerable efforts to clean up their balance sheet and to obtain capital injections from owners and government bodies within the framework of the Financial Market Stabilisation Act (*Finanzmarktstabilisierungsgesetz*). The tier 1 capital ratio of the German banking system as a whole has risen from 9.0% at the beginning of 2008 to currently 10.8%.

In absolute figures, the 14 German banks participating in the stress test show aggregate tier 1 capital of €146 billion and €139 billion in the respective stress scenarios at the end of 2011, compared with €150 billion at the end of 2009. The change in tier 1 capital is due primarily to the losses – induced by the assumed shocks – in their banking book financial assets totalling €36.7 billion, the estimated trading book losses totalling €5.8 billion and – in the supplementary stress scenario – additional losses resulting from the increase

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<sup>1</sup> Defined as Tier 1 capital aggregated over all participating banks divided by the risk weighted assets aggregated over all participating banks.

in yields on European government bonds totalling €8.9 billion. These must be counterbalanced against (cautiously estimated) expected pre-impairment income (including operating expenses) totalling €43.6 billion and the banks' other reserves. The risk-weighted assets of the banks participating in the stress test rose from a total of €1,428 billion to €1,637 billion, due primarily to the pessimistic assumptions regarding rating migrations of securitisation positions and to scenario-induced increases in the probability of default and loss given default ratios for the banking book exposures.

Only one bank, Hypo Real Estate Holding AG, posts a tier 1 capital ratio of less than 6% in the supplementary stress scenario in one of the two years in question. Here, too, an immediate need for capital would arise only if the hypothetical stress scenario actually did materialise: this bank complied with the regulatory minimum tier 1 capital ratio, even in the most severe stress scenario. Hypo Real Estate Holding AG is currently undergoing a far-reaching restructuring process under the close surveillance of its sole owner, the Financial Market Stabilisation Fund (SoFFin). A deconsolidated environment ("Abwicklungsanstalt") has already been established in accordance with section 8a of the Financial Market Stabilisation Act – although this could not yet be taken into consideration in the stress test analysis – to which risk positions totalling approximately €210 billion are to be transferred shortly. With that, an important step ensuring the ongoing viability of Hypo Real Estate Holding AG will have been taken.

#### **Annex 1: Table of capital ratios per bank**