

## Press Release 34/2016

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### 2016 stress tests: Italian banks don't look worse than German large commercial banks

The European Banking Authority today presented the results of the 2016 stress tests. They show that most European banks appear more or less stable. "What worries me is, however, that the Italian banks do not look worse than the large German commercial banks," says Reint E. Gropp, president of the Halle Institute for Economic Research (IWH). "It appears that both Deutsche Bank and Commerzbank would benefit significantly from an increase in equity. The stress test was also missing two crucial points: One, the effect of a long lasting low interest rate environment on banks was not simulated. And second, the test did not take into consideration that many small institutions could fail at the same time. This is not an unlikely scenario, given how small banks in particular struggle with shrinking interest margins," says Gropp. Finally, the stress test should not distract from the urgency to solve the problems in the Italian banking system.

As expected, Italian banks looked fairly bad in the stress test. However, they do not seem to look any worse than the large German commercial banks (perhaps with the exception of Banca Monte dei Paschi di Siena). Both sets of banks come out with CET1 ratios of just above 7%, which constitutes the minimum under Basel III, which will become effective in 2019. This is disconcerting against the backdrop of the current Italian banking crisis. A quick recapitalization not only of the banks in Italy seems advisable, particularly given that most observers consider this stress test to have been quite mild. This is even more true, if one considers that the stress test did not even consider the effect of a long lasting low interest environment on small banking institutions. Small banks have fewer possibilities to substitute away from shrinking margins in their core loan business and cannot easily absorb or offset losses there. This concerns Germany most strongly, given that the German banking system is still characterized by many small savings banks and credit unions, who in sum account for more than half of the banking system. Taken together, these banks are far more important for the German economy than Deutsche Bank. The existing safety net, in which these institutions insure each other, would most likely be over-stretched in the face of many institutions failing simultaneously.

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The more or less positive result of the stress test should also not distract from the urgency to solve the problems in the Italian Banking system. „In Italy it is just high time that finally the legacy bad assets are removed from the books to facilitate new lending. For this to happen, the losses need to be fully recognized and subsequently moved outside of the banks, while simultaneously increasing their capital. This must be associated with a bail-in of large stakeholders, in order to be incentive compatible. A protection of small scale holders of subordinated instruments issued by banks, which is common in Italy, seems possible without violating the rules of the new Single Resolution Mechanism,“ says Gropp.

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