Fitch Ratings

Banks

Europe
Special Report

European Bank Exposure to GIPs:

Second Order Risks More of a Concern Than Direct Holdings of Sovereign Debt or Bank Exposures

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Related Research

Applicable Criteria

- *Global Financial Institutions Rating Criteria (August 2010)*
- *Short-Term Ratings Criteria for Corporate Finance (November 2010)*

Other Research

- *German Banks' Exposure to Greece' (May 2011)*
- *Fitch Downgrades Five Greek Banks on Sovereign Downgrade; Places Them on Watch Negative (May 2011)*
- *Major French Banks' Exposure to Greece' (May 2011)*
- *Fitch Puts Bank of Cyprus on RWN; Downgrades Marfin Popular Bank Due To Greek Exposure' (June 2011)*
- *Irish Senior Bank Creditors - Can Ireland Do It the Danish Way?' (February 2011)*

Summary

With a handful of exceptions — notably the Greek banks themselves — major European commercial banks' exposure to Greek sovereign risk is not by itself large enough to justify some market concerns over the bank solvency implications of some kind of Greek restructuring or rollover event. Foreign bank holdings of Irish and Portuguese sovereign debt are also generally modest.

However, with several of Europe's largest banks still repairing balance sheets and rebalancing funding profiles, Fitch Ratings' primary concern about Greece, Ireland and Portugal (GIPs) would be the risk of a disorderly contagion spiral, evidenced by a sharp increase in creditor risk aversion to European banks. Most major European banks have used the past two years to enhance solvency and bolster liquidity. They would at least face such a situation with considerably better balance sheets than during the market closure that followed the Lehman Brothers default in 2008.

Provided contagion risks can be relatively quickly contained, most major European banks should be able to absorb the immediate credit, market and liquidity risks with only minor, if any, negative rating actions to IDRs and Individual Ratings. Such actions would probably be restricted to weaker banks in other countries where a Greek restructuring might trigger a negative sovereign rating action, and possibly to Cypriot or smaller Spanish banks, where Greek exposure or refinancing risks are high.

However, should contagion risks amplify and lead to a protracted period of severe bank and/or sovereign risk aversion, many more European banks would be at risk of negative rating actions. Most at risk would be wholesale-funded banks with direct exposure to peripheral euro-zone risk and banks still in rehabilitation mode.

Greece: Fitch has identified approximately EUR37bn of Greek sovereign debt held by 34 major European commercial banks not domiciled in Greece. In total, these holdings are equivalent to a small fraction — approximately 4% — of these banks' aggregated Tier 1 capital. A Greek sovereign default would have minor direct consequences for the solvency of most European banks.

By contrast, the major Greek banks have EUR45bn of Greek sovereign debt. This is equivalent to 160% of their total equity, making their risk profiles closely tied to Greek sovereign risk. Cross-border European bank exposure to the Greek banks is very low, meaning that there would be negligible follow-on credit losses from this source should a Greek sovereign default trigger a default by Greek banks.

Ireland: Except for Irish banks, major European banks' direct exposure to Irish sovereign risk is low, with about EUR6bn held by 32 banks. Corporate and retail banking exposures represent a moderate source of potential risk for a handful of banks (e.g. Lloyds Banking Group plc, The Royal Bank of Scotland Group (RBS), KBC Group and Danske Bank), but cross-border exposure to Irish banks is very small.

Portugal: The Portuguese banks are the most exposed to Portuguese sovereign debt - the top 5 have around EUR17bn of exposure at end-2010. Otherwise, around EUR20bn of Portuguese sovereign debt exposure is held by 31 major European banks with aggregated Tier 1 capital of EUR900bn. A handful of the Spanish banks and UK-based Barclays Bank plc have banking operations in Portugal, with Banco Santander by far the most exposed via Santander Totta SGPS.

Exposure to Greek Risk

Huge Risk Exposure of Major Greek Banks to Greek Sovereign Debt

The five major Greek banks rated by Fitch — National Bank of Greece S.A., EFG Eurobank Ergasias S.A., Alpha Bank, Piraeus Bank and Agricultural Bank of Greece (ATEbank) (all 'B+'/Rating Watch Negative (RWN)) — have a substantial EUR45bn of exposure to Greek sovereign risk in addition to their lending operations to the Greek private sector. This alone ties their risk profiles very tightly to that of the sovereign, as a Greek restructuring or rollover would have direct implications for the banks' solvency. Only Alpha Bank's exposure is equivalent to less than 100% of equity (see Figure 1).

In the worst case, a disorderly restructuring or rollover of Greek government debt would materially increase the likelihood of Greek bank default due to a further critical tightening of liquidity and reduced confidence. The worst-case scenario would be a shut down of the liquidity line from the ECB by, for example, no longer accepting Greek banks' government or government-guaranteed bonds as collateral, although liquidity could possibly be supplied indirectly through the Greek central bank, as has been the case in Ireland.

Concerns around the Greek banks also centre on the risk of a further deposit outflow and/or a deficit of collateral available for the discount facility. As long as the terms of any restructuring or rollover are acceptable to the ECB, it seems logical that it would continue to accept restructured or rolled over Greek government bonds or government-guaranteed bonds as collateral for discounting, provided the banks pledging the collateral are solvent.

See also *Fitch Downgrades Five Greek Banks on Sovereign Downgrade; Places Them on Watch Negative*, published 23 May 2011.

Cypriot Bank Exposure to Sovereign and Non-Sovereign Greek Risk Also Notable

Bank of Cyprus Public Company Ltd (BOC; BBB+/RWN) and Marfin Popular Bank Public Company Limited (Marfin; BBB−/Stable) have large exposures to Greek risks, mainly in the form of loans and their sovereign debt exposures are also relatively high (see Table 1).

Marfin (46% of its loan book) is more exposed to overall Greek sovereign and economic risk than BOC (35%), which largely explains the two-notch difference between the banks' ratings. Marfin's funding profile is also weaker than BOC's, with greater reliance on ECB funding. (See also *Fitch Puts Bank of Cyprus on RWN; Downgrades Marfin Popular Bank Due To Greek Exposure*, published 1 June, 2011.)

Figure 1

Selected Larger Exposures to Greek Sovereign Debt

(EURbn)	Sovereign exposure (A)	Tier 1 (B)	A/B (%)
National Bank of Greece	18.6	8.7	214
Efg Eurobank Ergasias	8.8	5.8	152
Alpha Bank	4.6	5.8	80
Piraeus Bank	8.7	4.0	217
ATEbank	4.2	0.8	525
Bank of Cyprus	1.8	2.9	62
Marfin Popular Bank	3.0	3.3	91

Source: Banks' publications and Fitch calculations, end-Q111

Limited Sovereign and Economic Exposure for Most Other Major European Banks

Data from the Bank for International Settlements (BIS) estimates foreign bank exposure to Greek sovereign debt to be approximately EUR50bn. Fitch assesses around EUR37bn of this to be held by 35 major European commercial banks, including approaching EUR5bn by BOC and Marfin.

France & Germany: Fitch estimates the Greek sovereign debt exposures of the major French and German commercial banks to be approximately EUR11bn and EUR8bn, respectively. Fitch's data for Germany excludes substantial exposures that are with KfW ('AAA', which has a EUR22bn loan commitment on behalf of Germany to Greece), or were transferred by the former Hypo Real Estate Bank (now Deutsche Pfandbriefbank AG) and Depfa Bank plc to the German run-off institution FMS Wertmanagement Anstalt des oeffentlichen Rechts ('AAA'; around EUR10.8bn of aggregated economic exposure, mostly government bonds). Such exposures are effectively at the risk of the German sovereign.

While a sovereign default and haircut would directly dent bank earnings for a short period, French and German bank exposures to Greek sovereign risk are for the most part small relative to the overall solvency of banks in question (typically less than 10% of equity, often significantly so). Higher exposures were held by France's La Banque Postale and Deutsche Postbank at the latest reporting date. However, relative exposure has reduced since due both to lower exposures and to equity increases at both banks.

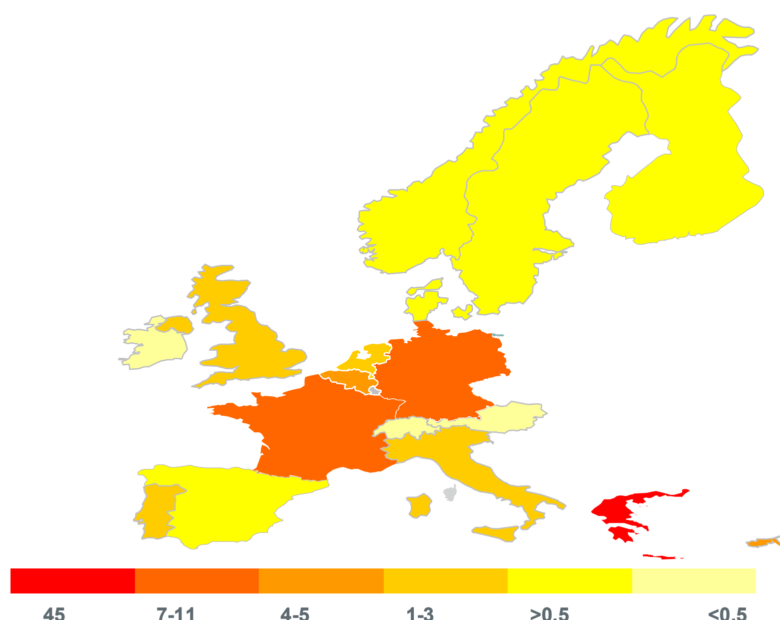
Credit Agricole (CA; 'AA–') is the most exposed French bank to overall Greek risk, mainly due to its ownership of heavily loss-making Emporiki Bank of Greece (EUR21bn of loans; 26% non-performing loan ratio). CA has already injected EUR2bn of fresh capital into Emporiki since 2008, and was providing EUR15bn of funding at end-Q111 (EUR11bn net of deposits placed back with CA group entities), largely reflecting a decision not to participate in a deposit war.

Under a severe (hypothetical) stress test, in which the principal source of losses is a 33% default rate applied to Emporiki's loan book, Fitch estimates that Emporiki could need around EUR2bn more capital in order to maintain current capitalisation levels. This could be very comfortably absorbed by CA in the context of its EUR75bn equity base and strong liquidity.

For a much detailed analysis of German and French bank exposures to Greece, see *German Banks' Exposure to Greece*, published 27 May 2011, and *Major French Banks' Exposure to Greece*, published 16 May 2011.

Figure 2

Selected Major Bank Exposure to Greek Sovereign Debt (EURbn)



Source: Public disclosures & Fitch

Other countries: Dexia, with EUR3.4bn of exposure at end-2010 in its banking book, also has a relatively high exposure in relation to its tier 1 capital base. Because regulatory capital does not take account of negative revaluation reserves, Dexia's tier 1 ratio is high, meaning an isolated Greek restructuring would not have a material impact on regulatory capital. However, Greek sovereign exposure represented a significant percentage of Dexia's Fitch core capital (FCC, which includes negative revaluation reserves) of EUR3.8bn at end-2010, which partly explains Dexia's low Individual Rating of 'D'.

Most other European banking systems have far less direct exposure to Greek sovereign risk, so even very severe haircuts on Greek sovereign debt would in isolation have a negligible impact on solvency.

In Austria, the major commercial banks have modest holdings of Greek sovereign debt. However, it is worth noting that KA Finanz AG has around EUR1bn of exposure to Greek sovereign and public sector debt. KA Finanz is the run-off vehicle for the former Kommunalkredit Austria's non-core assets, 99.78% owned by the Republic of Austria, so this is effectively at the risk of the Austrian sovereign. Meanwhile, the new Kommunalkredit Austria, which Fitch does not include as a "major commercial bank" in the heat map above, has high exposure to Greece relative to its capital size, but, like Dexia, has a low 'D' Individual Rating.

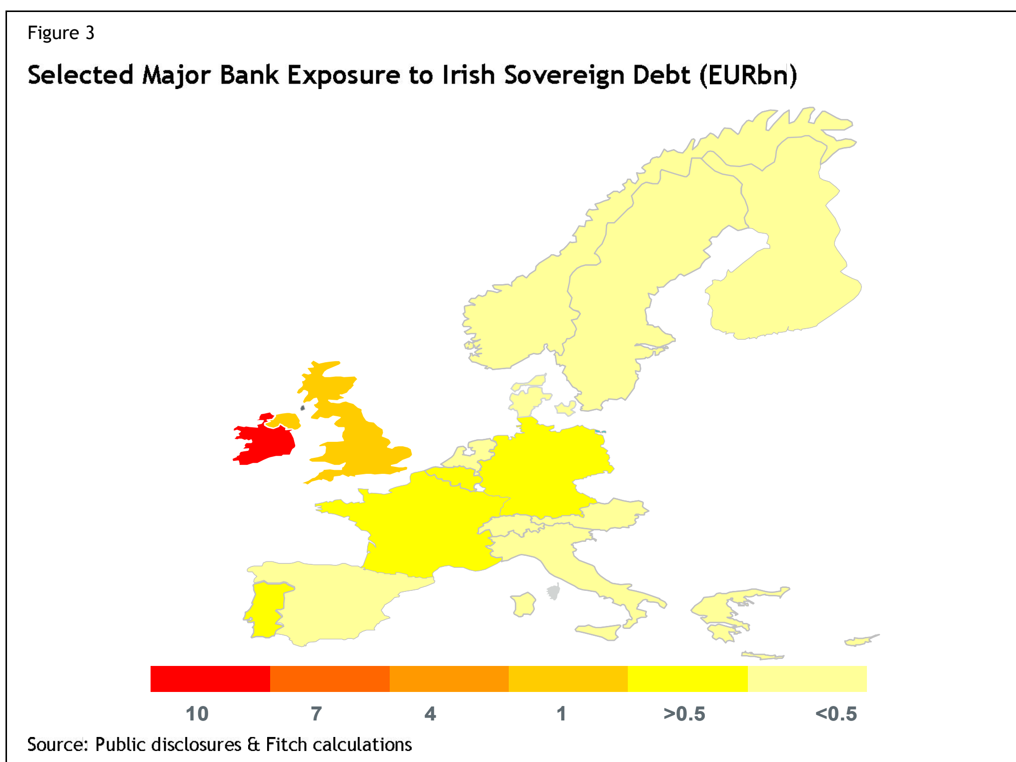
Cross border risk: European bank exposure to Greek banks is very limited (except for intragroup exposure such as CA and Emporiki). Cross-border lending to Greek corporates is often collateralised and/or not very correlated to Greek economic risk (e.g., shipping), and thus is not a major source of concern.

Exposure to Irish Risk

Huge Irish Bank Exposure to Sovereign Risk is Mostly via NAMA Bonds and Promissory Notes

Figure 3

Selected Major Bank Exposure to Irish Sovereign Debt (EURbn)



Source: Public disclosures & Fitch calculations

The main Irish banks have around EUR11bn of sovereign debt. However, this understates their exposure to Irish sovereign risk, as it does not include around EUR31bn of bonds received from the National Asset Management Agency (NAMA) in

return for the EUR72bn of loans (mostly commercial property) transferred off the banks' balance sheets during 2010. On top of this, the banks in run-off — particularly Anglo Irish Bank Corporation Ltd, but also the smaller Irish Nationwide Building Society ('BB-'/RWN) — have another EUR30bn of Irish promissory notes received as part of their re-capitalisation.

In its report *Irish Senior Bank Creditors - Can Ireland Do It the Danish Way?* published on 23 February 2011, Fitch explored in more depth the very closely linked default risk of Ireland's main banks and the sovereign itself.

Other European Banks Have Negligible Exposure to Irish Sovereign or Bank Debt

Fitch estimates holdings of Irish sovereign debt by major European commercial banks to be just EUR6bn, held by 32 banks. No banking system has exposure that could in any way be considered a material threat to solvency (see Figure 3). The same is true of any individual major bank. RBS had very modest sovereign debt holdings, but also around EUR2bn of quasi-Irish sovereign risk via placements by Ulster Bank Ireland Limited with the Central Bank of Ireland.

Excluding intragroup exposures (for example RBS to Ulster Bank/Ulster Bank Ireland), cross-border exposure to Irish banks is also very limited.

Loan Book Exposures of Lloyds, RBS, KBC & Danske are More of a Risk

Of the major European banks rated by Fitch, only RBS ('AA−'), Lloyds Banking Group (Lloyds; 'AA−'), KBC Group (KBC; 'A') and Danske Bank (Danske; 'A+') have banking operations worthy of note in the Republic of Ireland and Northern Ireland. Although the crisis in Ireland is now into its fourth year, the economic recovery is weak (Fitch estimates GDP growth of just 0.5% in 2011) and asset quality has not yet stabilised. For example, residential mortgage arrears (over 90 days) are around 12.5%, including mortgages that have undergone restructuring (source: Central Bank of Ireland). Northern Ireland has not experienced the same property crisis as the Republic, but asset quality is still a concern. As a result, 2011 will be another challenging year for the Irish operations of these banks.

RBS is the most exposed via its ownership of heavily loss-making Ulster Bank and its subsidiary Ulster Bank Ireland. These banks are rated 'A+' on the basis of the considerable capital and funding support that has been (and is likely to continue to be) made available by RBS. Their Individual Ratings of 'E' reflect their very weak standalone risk profiles.

RBS has around EUR50bn of net loan exposure to the republic and Northern Ireland via these subsidiaries, mostly (roughly three-quarters) south of the border. This is equivalent to around 9% of RBS group loans. Fitch expects Ulster Bank to require further capital injections in 2011 to offset losses on its loan book, where non-performing loans are currently running at around 26%.

Although the scale of RBS Group's Irish exposure is moderate in relation to the group's considerably bolstered capitalisation (EUR59bn of core tier 1 capital at end-Q111 and a core tier 1 ratio of 11.2%) and liquidity, it will represent an earnings drag for at least the rest of this year.

Lloyds: Lloyds has a smaller exposure to Ireland than RBS (around EUR24bn of net loans). However, its quality has proven weaker to date because of a greater weighting of exposure towards commercial real estate, where non-performing loans and loss rates have been very high. Although over half of Lloyds's Irish loans are impaired, reserve coverage looks appropriate.

While Fitch expects Ireland to continue to weigh on Lloyds's earnings in 2011, the overall net loan exposure of EUR24bn is relatively small in the context of Lloyds's large balance sheet, being equivalent to less than 4% of group loans. The tail risk looks manageable.

Danske: Danske has operations in the Republic of Ireland and Northern Ireland, with loan book credit exposure aggregating to around EUR15bn, split 55:45. Fitch considers commercial property exposures in the Republic to be the greatest source of risk. Although these exposures are likely to remain a drag on earnings, the net non-performing exposure is manageable relative to Danske's core capital.

Commercial property exposure is also significant in Northern Ireland, but asset quality although not strong, is less weak than in the Republic, and Fitch expects more moderate losses from these exposures. Fitch expects that losses related to Danske's EUR6bn personal customer lending in the Republic of Ireland and Northern Ireland should also be manageable.

KBC is mainly exposed, through a fully owned subsidiary, to residential mortgage risk in Ireland and has largely avoided commercial real-estate. While residential mortgage quality is likely to weaken, as the total Irish book (EUR17bn at end-Q111) is equivalent to only 11% of group loans, the downside risk should be containable.

German Bank Exposure to Irish Risk Much Lower Than BIS Data Suggests

As Fitch noted in its Special Report *German Banks' Exposure to Greece*, BIS numbers for German banks' country exposures can be misleading, because banks' exposure is reported on an "immediate" risk basis for German banks, whereas other countries report on an "ultimate" risk basis. For example, when a special purpose vehicle (SPV) is set up in Ireland to acquire receivables from a German corporate, on an immediate risk basis the exposure would be allocated to "Ireland". On an ultimate risk basis, the location where the final risk lies decides the allocation to a country, in this concrete example "Germany".

The difference is very stark in the case of German banks' exposures to Ireland, and explains to a large extent the misunderstanding that German banks have an enormous exposure to Irish banks and corporate risk.

German banks took advantage of the low corporate tax in Ireland compared to Germany, and set up banking subsidiaries that function as booking stations for international interbank lending, asset-backed securities (ABS) and loans to European corporates. These banks' assets incorporate no or very little Irish risk, and are funded by their parent and other German banks. Similarly, German banks finance international leasing and finance companies that are headquartered in Ireland, and also own covered bonds issued by DEPFA ACS Bank.

In addition, German banks have set up SPVs in Ireland for ABS transactions backed by assets with few or no links to the Irish economy. As a consequence, Fitch believes that the German banks' exposures to Irish risks are much lower than the BIS numbers might suggest (see Figure 4).

Figure 4

German Banking System's Exposure to Irish Risks BIS and Fitch

		Fitch	
(EURbn)	**BIS**	**Gross**	**Net**
Public sector	2.5	2	2
Banks	42.2	6.9	6.6
Non-public private/corporate	68	7.5	5
Total	**113**	**16.4**	**13.6**

Source: BIS March 2011, Fitch's May 2010 and May 2011 data requests and estimates.

Exposure to Portuguese Risk

Sovereign Exposure Greater Than to Ireland, But Less Than to Greece

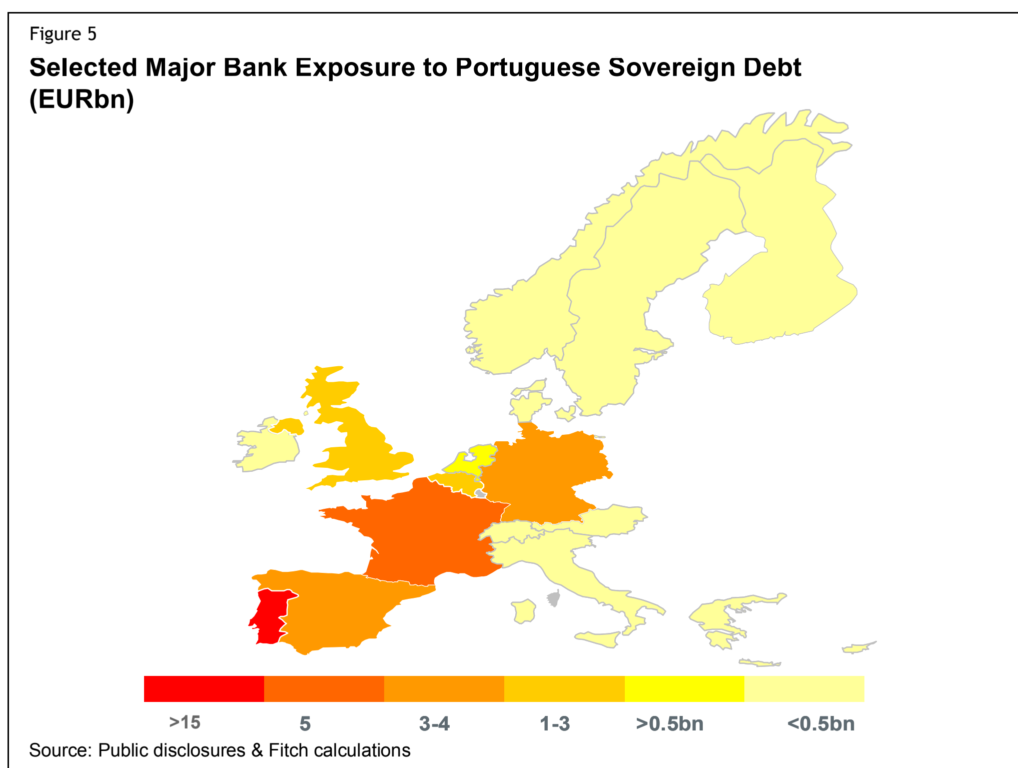
The five major Portuguese banks are most exposed to Portuguese sovereign debt, with around EUR17bn of holdings at end-2010. Cross-border holdings of Portuguese sovereign debt total around EUR20bn by 31 banks – higher than Irish debt holdings but still moderate in relation to their tier capital of some EUR900bn.

France: As with cross border exposure to Greek sovereign debt, the most exposed are the major French commercial banks, with aggregated exposures of around EUR5bn.

When combined with their Greek and Irish sovereign exposures, major French commercial banks' exposures to these countries' sovereign debt is equivalent to 6% of the banks' capital. In an extreme event, under which all three sovereigns default and loss rates (after tax) reach 40%, the hit to the sector's capital in respect of these banks would be around EUR6bn. By way of comparison, the major French banks reported aggregated net income of EUR25bn in 2010. In isolation, therefore, the immediate credit losses arising from such a scenario would hurt earnings rather than solvency.

Figure 5

Selected Major Bank Exposure to Portuguese Sovereign Debt (EURbn)



Source: Public disclosures & Fitch calculations

Spain: The major Spanish banks have limited trading operations, and it is perhaps not a surprise that their holdings of Portuguese sovereign debt are very modest (in the EUR3bn-EUR4bn range). However, the materiality threshold is arguably lower, given weakened state of market confidence in the Spanish banking sector, notably the troubled smaller savings banks.

Apart from UK-based Barclays Bank, which has a small Portuguese loan book of around EUR7bn, a small number of Spanish banks are most exposed to Portuguese lending risk. Due to the weak economic backdrop and a leveraged private sector, Fitch expects asset quality in Portugal to weaken, even if the risk of a sharp deterioration is alleviated by the absence of a housing or economic boom over the past decade.

Banco Santander ('AA') is the most exposed, via its Banco Santander Totta SGPS subsidiary, whose EUR30bn loan book was equivalent to only 4% of Banco Santander's consolidated loans at end-2010. Loans are split 48%/52% between corporate (largely SME) and retail (mostly residential mortgages). The ratio of 90 day overdue loans remains moderate at 2.4%, but is likely to deteriorate as a result of the weak economic outlook for the Portuguese economy.
Banco Popular Espanol S.A. (BPE; 'A') has around EUR8bn of commercial banking exposures in its Portuguese subsidiary, Banco Popular Portugal SA (BPP). In addition

to its equity exposure, Banco Popular Espanol provides a material (around 50%) amount of cross-border funding to BPP, which ties BPE more closely to Portuguese risks than were BPP more deposit-funded.

Although equivalent to less than 10% of group loans, the risks for BPE arising from its exposure to Portugal are greater than they are for Banco Bilbao Vizcaya Argentaria (BBVA; 'AA−'), where Portuguese loan risk is equivalent to only around 2% of group lending.

Second Order Risks

Contagion Fears and Extreme Market Risk Aversion Represent Main Risks to European Banks From Greek Default

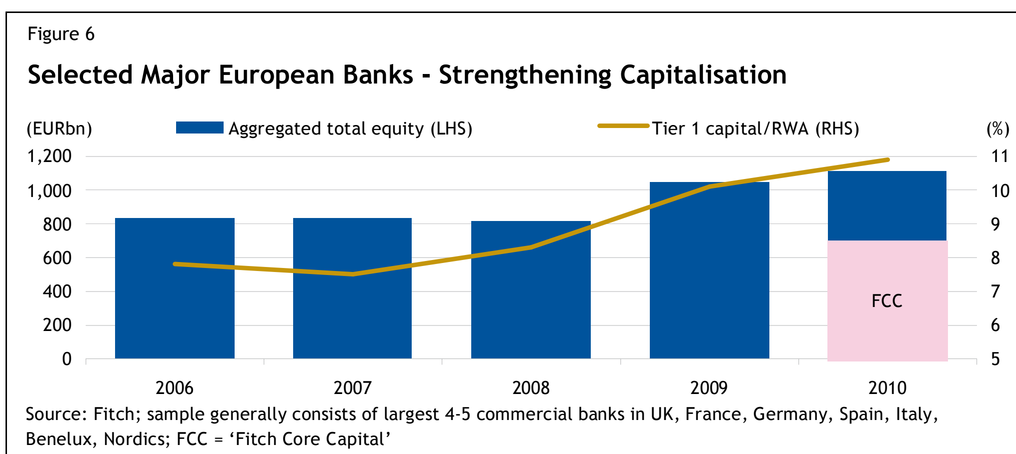
For most major European banks, the direct solvency impact of a Greek sovereign debt restructuring or rollover would generally be limited. The secondary risks, however, could create the most risk.

Contagion: A Greek restructuring or rollover has the potential to create immediate incremental pressure on Irish and Portuguese sovereign and bank risks, exacerbating already high investor risk aversion to these counterparties.

While European bank exposures to these risks are not material enough to represent a significant direct source of credit loss risk, the contagion effect would be likely to trigger broader risk aversion and cause liquidity to contract sharply in the critical money and capital markets. After Ireland and Portugal, countries like Spain and Italy would see most pressure. This would be of particular concern for the medium-sized and smaller Spanish banks that have been weakened by the domestic real-estate crisis and that are struggling to de-risk, deleverage and refinance. Fitch believes that the recent increase in utilisation of ECB funding by Spanish banking sector (up to EUR57bn at end-May 2011 from a EUR42bn low in March, albeit still well down on the EUR139bn peak reported in July 2010) is largely due to higher utilisation by medium-sized Spanish banks.

Figure 6

Selected Major European Banks - Strengthening Capitalisation



Source: Fitch; sample generally consists of largest 4-5 commercial banks in UK, France, Germany, Spain, Italy, Benelux, Nordics; FCC = 'Fitch Core Capital'

Overall, however, the large European banks hit hardest by the 2008-2009 financial crisis have made considerable progress in boosting solvency, deleveraging, cutting risk, reshaping funding bases and boosting solvency (see Figure 6). As a result, many banks ought to be able to withstand the pressure, provided it proves relatively short-lived. Negative rating actions would be likely to be linked to any knock-on negative sovereign actions in other countries and to banks with greatest direct exposure to GIP risks and/or the weakest funding profiles. The risk of negative rating actions would be greater the deeper the contagion and more protracted any funding market disruption. Under such scenarios a much broader spectrum of European banks would be vulnerable to IDR and/or Individual Rating downgrades.

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