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# SPECIAL REPORT

## BREXIT AND THE EUROZONE CRISIS:

### PROTECTING YOUR FINANCIAL FUTURE IN THIS NEW WORLD ECONOMY

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4400 Northcorp Parkway, Palm Beach Gardens, FL 33410
Phone: 877-934-7778
www.weissratings.com

# Foreword

By Martin Weiss Ph.D. – Chairman, Weiss Group

If you think Britain's exit from the European Union is going to be a shock to the economy, wait till you see the potential dire straits of Europe's most vulnerable banks.

I can discuss this topic with precision because the day that our Weiss Ratings division has updated the first-ever, independent and objective safety ratings of the largest global banks in the world was the day Britain voted to exit the E.U.

We are independent because, unlike Moody's, S&P or Fitch, we accept no compensation whatsoever from the rated institutions. Unlike those Big Three agencies, we also never give the institutions a "preview" of their ratings, never allow them to "appeal" ratings they disagree with, and never suppress publication at their request.

That's why the U.S. Government Accountability Office (GAO) found that the Weiss Ratings of insurance companies greatly outperformed those of Moody's, Standard & Poor's, A.M. Best and others in warning consumers of future failures.

It's also probably why a study reported in *The Wall Street Journal* demonstrated that our original Weiss Stock Ratings outperformed those of all major Wall Street banks and research organizations.

### Average Rating of Eurozone Banks: Absolutely Astounding

We apply these same principals — conflict-free research and accuracy — to our global bank ratings, and here are the big-picture results, based on March 31, 2016, data …

1. Among banks in North America, the average Weiss Safety Rating is **C+**. On our rating scale, which is similar to school grades, that's "fair," a passing grade.

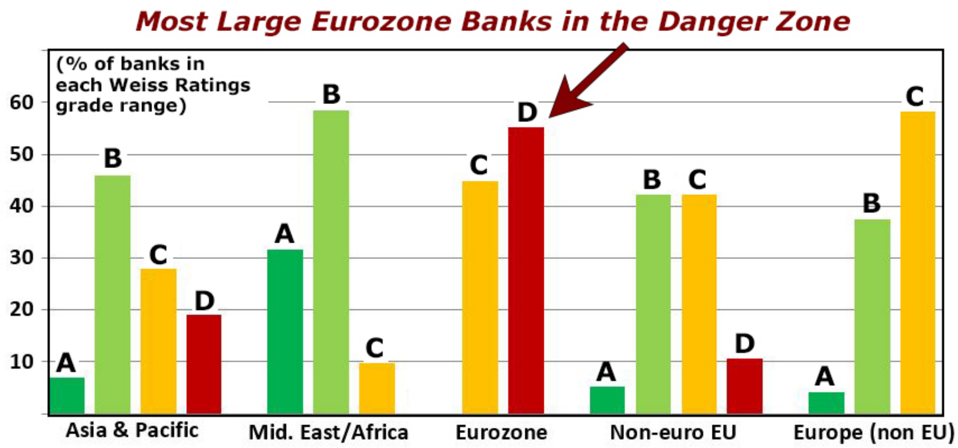
2. In the Asia and Asia/Pacific region, the average rating is **C+** ("fair").

3. And surprisingly, big banks in the Middle East and Africa, despite troubles in certain regions, merit an average grade of **B** ("good").

4. But …

> In the eurozone countries, the average Weiss Safety Rating of the institutions we cover is D+ (weak) — a red-light warning, especially in the wake of last week's Brexit vote.

The chart below shows exactly how the grades are distributed among banks outside of the Americas:




The eurozone has the most astounding concentration of large weak banks I've ever seen in all the 45 years since I founded my research and ratings company:

Among the banks we cover in the region, 57.9% get a Weiss Safety Rating in the **D** range (D+, D or D-), while the balance (42.1%) get no better than **Cs**.

This contrasts with Asia and the Asia-Pacific, where 46% of the institutions are in the **B** range and only 19% are **Ds**. And it contrasts even more sharply with the Middle East and Africa where 58.5% are **Bs** and there are no Ds.

What's most illuminating of all, however, is the contrasts inside Europe itself:

- If a bank is based in an EU country that does *not use the euro* (such as the U.K., Sweden and Poland), it's less likely to have financial weaknesses than eurozone countries like Spain, Italy, France or even Germany.

- And if a bank is based in European countries outside of the European Union entirely, such as Switzerland or Norway, it's even less likely to have problems. (You can see this in the last group of bars in the chart above.)

Evidently, the European Union has not been good for the financial stability of most banks. And the euro currency has been even more damaging.

I repeat: The eurozone has the worst concentration of large, weak banks I've seen since we began scrutinizing bank financials back in 1971.

### What About Prior Banking Crises?

No, it's not the first time I've seen many banks in the danger zone. In the 1980s, for example, almost one-third of the U.S. banks and S&Ls we rated were in that category. And in the years that followed, 3,700 failed.

Nor is it the first time that megabanks have been vulnerable to failure. In 2007, for instance, we issued D ratings for some of America's largest … we got frequent flack for our low grades … and later, *after* they failed, occasional accolades.

Rather, what's so surprising in this instance is that the AVERAGE grade, including ALL of the institutions in the eurozone that we cover, is so low.

Of course, the preponderance of Ds doesn't mean that dozens of banks will start failing tomorrow. Nor does it mean that every single one with a bad grade will ultimately go under. But it does signal three things:

1. A higher-than-average *probability* of failure among large eurozone banks.

2. Systemic, eurozone-wide financial weakness that could cripple Europe's economy, with far-reaching global consequences.

3. Major vulnerabilities to a political or external shock, such as Brexit.

### Why Isn't This Headline News?

Yes, I know. All the headlines right now are about the Brexit vote. That's what has lit the fires, stirred the markets and padded media company revenues.

But the Brexit story could eventually die down. This one will not. Quite to the contrary, it could emerge as one of the biggest threats to the global economy, starting from Europe, spreading to Asia, and then to the Americas.

The likely shock waves follow a path that's similar to what my colleague Larry Edelson has described regarding the future financial difficulties of highly indebted governments: First Europe. Then Japan. And ultimately the United States.

And now, this data reveals a side of the debt pyramid that's often out of the spotlight, hidden behind inflated ratings, or simply covered up. Our goal is to break through those unfortunate barriers to your knowledge and to give you the tools you need to make prudent, informed decisions for your money.

## The 6 Weakest Among Large Eurozone Banks

So let me start by naming some names. Among the largest eurozone banks, here are the six weakest:

**Large Eurozone Banks:**

| Bank | Country | Weiss Rating |
|---|---|---|
| UniCredit SpA | Italy | D |
| Intesa Sanpaolo SpA | Italy | D+ |
| CaixaBank SA | Spain | D |
| Dexia SA | Belgium | D+ |
| Bankia SA | Spain | D+ |
| Banco de Sabadell SA | Spain | D+ |

All six of these institutions merit a rating of D+ or lower, which we consider to be a danger zone.

All have at least $200 billion in total assets.

And all have multiple reasons for their weaknesses …

**Low liquidity**, especially in the case of UniCredit SpA, Intesa Sanpaolo SpA, CaixaBank SA and Bankia SA.

**Large bad loans almost across the board**, except perhaps for Dexia SA.

**Poor asset growth**, also nearly across the board, with the possible exception of Intesa Sanpaolo SpA and Banco de Sabadell SA. Plus …

**Operating losses** at one of the six banks — Dexia SA.

So many troubles! And despite a seemingly never-ending series of capital infusions from governments that are, themselves, still mired in excess debts!

## Which Eurozone Countries Have the Weakest Banks?

Five of these six banks are based in Italy and Spain. One is in Belgium.

Meanwhile, most people think that German banks are very strong. But that's rarely the case.

Deutsche Bank merits a Weiss Safety Rating of only **C+**; both Commerzbank and Deutsche Postbank get a **C-**; and IKB Deutsche Industriebank, a **D-**.

According to the German financial watchdog Bafin, this is especially worrisome in the wake of the Brexit vote. “The biggest banks would have the biggest problems," says Bafin President Felix Hufeld. “They have the most activities in, and with, London.”

Specifically, Deutsche Bank and Commerzbank are the German banks with the largest business dealings in Britain.

### Your Action Plan:

1. Be sure to find out the Weiss Safety Rating of the institutions you rely on to safeguard your money and your finances, including not only banks but also credit unions and insurance companies.

2. Find out which ones are among the safest in your state.

3. If your money is in the danger zone, seriously consider moving it to a safer place. This applies to major regions in trouble like the eurozone as well as individual institutions.

4. Also look up the Weiss Investment Ratings for your stocks, ETFs and mutual funds.

To have all these resources at your fingertips, plus much more, go to www.weissratings.com.

Plus, as always, continue to build cash reserves to help prepare for unexpected black swan events that can be very disruptive to global financial markets — and very destructive to your investments.

Enjoy reading the report, it is full of data to help you make wiser investment decisions.

Best wishes,

Martin

Martin D. Weiss, Ph.D.

# How Brexit Threatens European Union and Global Banks

*by Gavin Magor, Weiss Ratings Senior Financial Analyst, and Remi Lukosiunas, Weiss Ratings Junior Analyst*

*"The eurozone has the worst concentration of large, weak banks I've seen since we began scrutinizing bank financials back in 1971." -* Martin Weiss, Ph.D.

There is no avoiding it. In this globalized world whether we like it or not we, in the U.S., are inextricably linked to the rest of the world, whether it is China or Europe.

When one country or region has a problem then this affects our trade, both imports and exports. Naturally this is a two-way street. We in the U.S. have already been affected by the U.K. voting to exit the European Union (E.U.).

Global markets were taken by surprise when the votes were counted in the U.K., as it became clear that Britain was going to leave the European Union after more than 40 years. Many, including Brexit supporters, were skeptical about the exit, thinking the demand to exit was over-hyped, and the Bremain vote would hold the day, much like the 2014 Scottish vote to separate from the United Kingdom.

### Casualties

Naturally the financial markets responded with volatility. Many of the initial market drops were simply taking back gains that had already factored in a Bremain victory. Subsequently the markets reacted positively as the political control of the country was resolved. There were two major casualties; First, the UK Prime Minister, David Cameron, who resigned. He was replaced by only the second female to hold the post, Theresa May, within weeks rather than the expected months. The second major casualty, and arguably the more important one globally, was the British Pound that dropped to the lowest point against the U.S. Dollar since 1985, bottoming out at $1.29.

On August 4, 2016 the Governor of the Bank of England, Mark Carney, announced that there would be a one quarter of one percent reduction in UK interest rates, from the previous low of 0.5%. This lowest rate ever naturally reinforced the low pound/dollar exchange rate. Although it would have been expected to have reduced the exchange rate, at this point there has not been any significant effect with the rate settling at $1.31 to the pound.

The governing Conservative party was not the only one to suffer. After weak leadership by Jeremy Corbyn, the leader of the opposition Labour party was criticized by a shadow cabinet member the critic was fired from his office.

The firing of a senior party member precipitated a wave of resignations from many other shadow cabinet members who were unhappy with the lukewarm support their leader had given to remaining in the E.U.

despite the official party stance. Strangely, after a vote of no confidence in his leadership was passed with a huge majority and further shadow cabinet resignations, Corbyn resisted demands to resign. Now he is in the middle of a re-election campaign forced upon him by the party.

The swift way the ruling Conservative party addressed the leadership problem contrasts with the almost open warfare of the Labour party. Although Theresa May was pro-Remain during the Brexit campaign she is determined to exercise the will of the British people and negotiate the Brexit from a position of absolute certainty. This confidence and clearly signaled intention to follow through, is essential for the country to demonstrate both the ability to continue in a leadership role on the world stage and that it is capable of enacting an effective and successful withdrawal from the E.U.

Here in the U.S. the Dow Jones Industrial Average Index was down over 600 points or 3.4 percent by the time the markets closed on the day the result was announced whilst the S&P 500 lost 3.6 percent. This shock-drop was followed shortly after by a bounce back and a strong rally that by mid-July put the DOW at record levels. A little cooling off period has followed, but as August gets underway it appears we are heading up, up and away.

Banks were among the many businesses affected by the U.K. decision to leave the European Union with both The Royal Bank of Scotland Group and Barclays down 38% the following Monday morning. These are both some of the largest global banks with $1.3 trillion and $1.8 trillion in assets respectively. Barclays has come back a little from its low of $7.03 to $7.96 on August 4, but The Royal Bank of Scotland Group fared worse with a double dip down to $4.16 before recovering to $5.06 on August 4. Following the release of second quarter results on August 5 RBS stock was hammered again, down 5.92 percent for the day.

## European Union in Turmoil

George Soros, the billionaire investor who made a fortune betting against the Pound as it exited the European Exchange-Rate Mechanism was not a supporter of a Brexit. Soros predicted chaos and you can be sure that he hedged his bets and took some aggressive positions on the GB Pound. In time, no doubt, he will reveal how much money he made on the enormous, in FX terms, drop in one of the world's major currencies.

Some E.U. countries, such as France appear to want to make an example of the U.K., not so much to encourage the remaining countries to see the benefits of remaining together as a block, but as a punishment for daring to leave. This is slightly ironic as France was against the U.K. joining what was called the European Common Market in the 1970's.

Germany appears more conciliatory, wanting the arrangements to be made as quickly and smoothly as possible, but appearing to recognize the reality that the U.K. is and always will be a major business and trading partner of Europe.

What was universal was the dislike of Prime Minister Cameron's announcement that any decision to leave the E.U. by invoking Article 50 will be the responsibility of his successor who, it was feared, might not be appointed until October. As we know now, Theresa May was appointed in July, but although she has had some discussions with other heads of state, she appears in no hurry to invoke Article 50 either.

This apparent lack of urgency is a clear signal of strength from the Prime Minister who has made it clear she will do what she believes is best for the UK, not the E.U. Although one of her initial appointments was the controversial one of Secretary of State for Foreign and Commonwealth Affairs, where she picked Boris Johnson, the face of the Brexit campaign - to the chagrin of many E.U. leaders, she also appointed a Secretary of State for Exiting the European Union.

The consequences for the E.U. and especially for the weaker eurozone countries appear significant given the annual contribution of 18.7 billion Euros that the U.K. currently makes. Anger is growing as the realization that the U.K. could take the E.U. into a destructive recession and squash the life out of the fragile economies of the PIIGS (Portugal, Italy, Ireland, Greece and Spain).

As you can see in the Global Bank Ratings report, many of these countries have very large banking institutions that are vulnerable and at serious risk in the current economic reality, let alone one where it worsens. The European Banking Authority released the results of its stress tests on July 29. These results bear out what our analysis showed and, indeed, the Italian bank Banca Monte dei Paschi di Siena S.p.A. received a bailout the following day.

## Does The U.K. Matter to Europe?

With the U.K. exit the European Union will no longer be the world's largest economy. According to the BBC the U.K. output of $2.86 Trillion will cause a drop of an estimated 17%, from $18.48 Trillion to $15.62 Trillion.

E.U. Global trade will reduce 3.8% to 18.2% and there will be a significant change in the balance of the E.U. with the GDP of Germany rising 5% to represent a quarter of all of the E.U. and France rising 3% to 18%.

Given the U.K. has a population of 65 million, the 13% drop in the E.U. to 443 million when compared to the contributions to the E.U. in output and budget suggests that it was a significant benefactor.

This is why although opinions are divided even in Europe about the decision some feel that the UK leaving will galvanize the EU to reform to prevent the pressures building up to the extent that any other countries feel that they also should leave. Many feel that the EU has stagnated and reform is essential.

Aside from the money, the U.K. acted as a buffer between the French desires for ever closer union and those countries that preferred a lesser amount of integration, such as Sweden. Now France will become more influential.

The question is whether the turmoil in Europe, that appears inevitable, and the short and medium term pain that the U.K. appears to be headed towards will be worth it. Long term the U.K. will clearly remain a power and given the successes of Norway and Switzerland who have operated in a peaceful coexistence with the E.U. while remaining outside it should be perfectly possible.

In the short term this apparently selfish decision, as judged by other members of the E.U., will have huge economic implications as countries, markets and companies are forced to re-adjust as the exit plan develops and without a concrete end-game.

This reactive strategy will cause uncertainty in the markets and naturally volatility. Money will be made by many, but also lost. The eurozone countries, ironically weaker than those remaining outside because of the requirement to make financial decisions according to incredibly complex rules, are already facing challenges. How the U.K. is treated by the remaining E.U. countries could help ease the transition or potentially eventually implode the E.U.

### Effect on the U.S.

The U.S. will be affected by the decision to leave the E.U. as imports become cheaper and trips to the U.K. become attractive with a weaker Great British Pound, if it continues. Gold may well rise in value and the potential for both inflation and a static economy (stagflation) in the U.K. and a negative effect on the already weak E.U. as our largest trading partner could be bad for exports.

A weaker Euro, or GB Pound, would continue to create pressure on pricing in the U.S. as to compete with the price of imports manufacturers will demand attention. One benefit may be that raw materials pricing could be positively affected. What is more certain is that with a continued anemic economy the E.U. will not be providing the U.S. with the export opportunities that it would like and the slow recovery from the Great Recession will be extended.

According to the BBC about one in 10 visitors to the UK is American. The exchange rate, at GPB 0.76 currently offers clear benefits but in the longer term it is not so clear that the current travel advantages will continue. The EU has favorable and reciprocal agreements on flights to and from the U.S. Once the U.K. leaves the E.U. these agreements will no longer be in force and new ones will need to be in place.

Exiting the E.U. will likely mean that the extensive cheap travel that Europeans have enjoyed, to and from the U.K., will be curtailed. To what extent this is not clear but if, as many in the U.K. want, migration is slowed then Ryanair and Easyjet, two of the largest cheap flight specialists operating around 600 aircraft between them may be forced to reduce their operations or at least cut back any expansion plans. Ryanair operates a Boeing fleet and Easy Jet operates Airbus. Small the effect might be at a global level, but this is one example of both the E.U. and the U.S. having the same interests.

Inevitably the continued downwards pressure on the U.K. and other European financial markets is not occurring in a bubble, with the Asian markets taking a particular dislike to the news of the Brexit vote.

The U.S. is not excluded as we saw in the early market reactions and this affects us all. If we hold investments in major U.S. companies, they are certainly going to be trading globally and will be affected by the fluctuations of those economies. Your 401K investments will inevitably depend on the performance of those same companies and perhaps companies based in those other markets. What happens in Asia and Europe will affect your retirement planning.

Bremain proponents and the E.U. believed that there is a very high possibility of a recession developing in the U.K. We have already discussed the potential for Stagflation but a recession in the U.K. or across Europe would be bad news for the U.S. and could put a stop to the everlasting bull market just as voters look to elect the new president.

Look for a flight to U.S. Treasuries to develop despite the low yields currently available, not necessarily from U.S. investors, but from other countries looking for a safe place to put their capital. Gold, in all its forms as bullion, mining stocks and ETFs may see substantial rises in the coming months if the volatility and uncertainty of the effect and implementation of the Brexit continues.

As the yields on Treasuries continue under pressure, mortgage rates will remain low and pressure on some property prices will grow as availability reduces because of continued foreign investment.

These uncertainties and negative pressures affecting the U.S. are why any rise in interest rates this year is starting to look less likely as depressing the markets is clearly something the Fed Chair Janet Yellen would like to avoid. The decision in June to hold rates clearly signaled that foreign events and the global economy in general were significant factors in the discussions. Rising interest rates are a factor in determining when it is time to move out of U.S. Treasuries, but with the potential for only small movements in interest rates and continued economic challenges elsewhere, now does not appear to be the time to abandon them.

U.S. based ratings agency, Standard & Poor's has downgraded the U.K. debt rating from the prestigious AAA level two notches to AA, Fitch downgraded it from AA+ to AA and Moody's left the rating at Aa1 but cut the outlook to negative.

Not helping the developing crisis was the decision by the leaders of Germany, France and Italy to refuse to hold informal talks with the U.K. on the Brexit until the official notification of the intention to leave triggers Article 50 of the Lisbon Treaty. Triggering Article 50 will start the execution of a simple five-point plan that requires the E.U. to negotiate the terms of the exit of the U.K. within two years, or the exit will be automatic and unconditional unless the member states agree to extend the term.

This is unlikely to be something the U.K. would want to see as it will not be participating in any discussions of the European Council or discussions concerning the U.K. Essentially the U.K. will be blackballed. Expectations that replacement agreements on trade, rights of abode, health care, pensions, travel etc. will take ten years to complete. In the meantime, the U.K. will have to negotiate separately with each country that the E.U. has made agreements with, including the U.S.   Such is the cost of independence.

What will not change will be the U.K. commitment to the defense of Europe under the auspices of N.A.T.O. It is this organization that guarantees the defense of any one of the other member countries in the event that it is attacked. Nervousness from former Eastern European countries is unnecessary. As with the U.S., Canada and Norway it is not necessary to be a member of the E.U. to be a member of N.A.T.O. and, in fact, some E.U. countries, such as Sweden and Finland are not members. The political machinations in the U.S., with Republican Presidential candidate Donald Trump questioning the value and continued unequivocal support for N.A.T.O. is of far more concern to E.U. nations.

## What Next?

Despite the Chancellor of the Exchequer (U.S. Treasury Secretary equivalent), and the Governor of the Bank of England both successfully putting out statements to try to steady the markets it has become clear there is still turmoil ahead. There is no tangible plan for an exit from the E.U. from either the U.K. or E.U. Legislation allowing for a member country to exit is so vague it clearly never anticipated being enacted, especially from a major member.

Businesses around the globe are bracing themselves for the difficult times ahead created by the exit vote. Companies operating in the U.K. can expect new regulatory hurdles, which may put a financial strain leading to possible job cuts and hinder current trade agreements. This may result in new regulations and added expenses for all involved.

Already we have seen the continuation of the financial industry threatening dire consequences because of the Brexit vote. JPMorgan Chase CEO Jamie Dimon indicated that re-evaluation of the location of offices would be undertaken.

Not that anyone expects that London will no longer play an important role in the financial markets but as a non-EU country it is almost guaranteed that jobs will move across to an EU country in the financial world. The promised protection of London as a center of the financial markets is gone. Prime Minister David Cameron had obtained a concession earlier in the year to help keep the U.K. as a member country.

When the Prime Minister of the U.K. invokes Article 50 the two-year exit clock will start. Although some informal planning will be no-doubt ongoing in the meantime it will not be until official notification takes place that anything can start. This is new territory for the E.U., the UK and for all the trading partners. The effects of each decision will have enormous implications for, not just the E.U., but also here in the U.S. because a downturn or recession in Europe will have global effects, especially on the banking industry.

There have been calls in the U.K. for the government to resign and trigger a new election where the parties should stand on the Brexit or Bremain issue. Neither of the two major political parties would want this to happen because they both fear that they would be decimated and a “hung Parliament” where no party holds control would be inevitable, serving no political purpose for them.

Despite the clear dissatisfaction of nearly half the electorate the current U.K. government will push forward with executing the wishes of the country as expressed in the referendum. Examining the referendum results shows that had 100% of those eligible had voted it would have taken a 59.8% remain vote from those that did not to have turned the decision around.

To put this in perspective that was the same margin that London voted for remaining in the E.U. and that was an exceptional result. This suggests that the mandate for leaving is substantial and, no matter the consequences, should be acted upon if the wishes of the electorate are to be followed.

The consequences on not invoking Article 50 and starting the exit process would have an even larger and more damaging effect on the democracy of the U.K. and would be political suicide for the ruling

Conservative party. This is why the new Prime Minister has categorically stated that Brexit will take place. Certainty brings confidence in decision making and the economies of Europe certainly need that.

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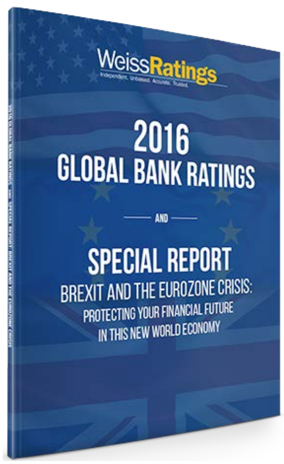
Thank you for reading our updated special report, Brexit and the Eurozone Crisis.

To see our latest safety ratings of banks, credit unions and insurance companies, visit WeissRatings.com

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