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The bank stress tests: a work in progress

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With the publication of the stress test results on July 23rd, the EU managed to turn the tide of growing uncertainty about the state of the European banking sector. National supervisory authorities in the EU demonstrated, probably for the first time in EU history, that they can work together effectively, under tight deadlines, and jointly analyse the soundness of the European financial system. The coordination by the Committee of European Banking Supervisors (CEBS) has set a standard for what the new European Banking Authority (EBA) should become, in close cooperation with the ECB and the European Commission. The priority now should be to make this a permanent and even more European initiative, to further harmonise the standards and coverage, and refine the findings.

The huge media attention on what is a very technical issue in the midst of the holiday period underlined the importance of the exercise. Mandated by the European Council only on June 17th, policy-makers and supervisors grasped the urgency of the situation and managed to deliver on time. The stress testing exercise was well prepared, well documented and fairly representative in its coverage. CEBS, and all national supervisory authorities discussed the results extensively, and informed their respective markets.

The Committee of European Banking Supervisors was able to organise the cooperation with a secretariat of only around 20 persons, and with the close involvement of the European Central Bank, both in terms of the technical aspects of the work and, by way of appropriate standing, with the involvement of a member of its executive board, Vitor Constancio, in the presentation of the results in London. This would suggest that both institutions are ready for the creation of the new bodies, the EBA and the European Systemic Risk Board (ESRB), as proposed in the de Larosière report, but it also confirms that a closer involvement of the ECB in financial stability matters has become a fact since the financial crisis.

But the exercise also had features of classic EU 'regulatory competition', and indicates where further work needs to be done. The average coverage of the European financial system was 65%, but some countries exceeded this by far, while for others the coverage was well below that figure. Spain, the initiator of the process as President of the EU Council, is a case in point, and included over 97% of its financial system, while for other countries, there was barely more than 50% coverage. Large member states, such as France and the UK, had only four banks included in the report, Italy had five (see list in annex of the CEBS report). Nothing is known about the other banks in these countries. The five Spanish banks singled out as problematic are all small local players, already in the consolidation process and needing no more than € 2 bn in additional capital, of no comparable size whatsoever to the German Hypo Real Estate, which is also on the blacklist. These national differences were also clear from the depth of the analysis and the degree of disclosure regarding individual banks.

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A second weakness is the measurement used, Tier 1 capital, following the definition of regulatory capital in the EU's capital requirements directive (CRD II). This criterion is now widely discredited, as it follows a weighted approach of risk, based on the assessments of credit ratings agencies, and with a zero-risk weighting for local currency sovereign debt of EU member states. Some banks thus passed the test easily, while their situation may be much more precarious in reality. This is above all the case for banks active in real estate finance, as such risk benefits from very advantageous weightings under CRD II. To have a more accurate view of the situation, write-offs should be deducted from the core capital, not from the risk-weighted capital.

A third weakness is the commonality of definitions and methodologies. Although the report stresses that common scenarios and methodologies were used, the question can be raised whether these are indeed sufficiently similar. The main concern is the following: for the more sophisticated banks, the bank-specific risk assessments are based on self-reported risk outcomes, or the so-called 'bottom-up approach'. The Summary Report affirms that the results were checked by the national supervisory authorities (§21-23 and §50), whether or not this level of scrutiny is effective is yet another question. For less sophisticated institutions, the national supervisors' models and ECB data were used. This means that while the more sophisticated institutions may have the ability to convince their supervisors of the accuracy of their own results, less experienced institutions simply have to live with the supervisors' assessments – no matter how inappropriate that may be. The different definitions used of non-performing loans is another query, with implications in terms of level of provisions and quality of assets. In sum, the methodology, and possibly the objectivity of the models, are not sufficiently comparable.

Further points could undoubtedly be made, but a precedent and a standard have been set for Europe-wide stress tests, which can only be improved over time. Some countries performed better than others in disclosing more and better information, which will force the others to upgrade. But supervisors are at last becoming European, something banks were told to be a long time ago.