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What it will take to make the next stress tests a success

By: Nicolas Véron



The banking crisis and the sovereign debt crisis are increasingly difficult to distinguish. Putting an end to Europe's current banking fragility is arguably the most important short-term financial policy issue in Europe. It is also an issue on which little progress has been achieved in the past two years. History tells us that resolute public intervention is the only way to clean up after a systemic shock such as the one experienced in 2008. Counting on low policy interest rates and high retained earnings to fill the capital gap is delusional.

The lesson of the past is that successful systemic banking crisis resolution involves three elements: triage, recapitalization and restructuring. "Triage" refers to a public capital assessment of all important banks in the system, on a genuinely comparable basis to credibly identify which banks are strong, which ones are weak and need more capital, and which ones are hopeless and must face either orderly liquidation or absorption by a sounder bank. This is the key function of stress tests. It is essentially what was done with remarkable success by the US authorities in the spring of 2009, and what two past waves of stress tests, in September 2009 and July 2010, have not achieved in Europe because of a flawed process and insufficient disclosure of results. As this is all about credibility, the fact that the EU has to start over for the third time is in itself not encouraging. Commissioner Olli Rehn announced this year's process will be "even more rigorous and even more comprehensive" than the previous two. There are three broad sets of questions about what this may mean in practice.

First, the information disclosed has to be significant. Last July, not enough was made public about the impact of individual risk factors on specific asset categories - though Spain did offer more transparency - and the results often relied on overoptimistic profitability forecasts. One would hope that this time the tests focus on so-called tier-one equity, a more rigorous capital yardstick, and give more detail on banks' balance sheets and how they react to different scenarios. Liquidity tests could be usefully added, even as the main focus should remain on capital and solvency. Sovereign risk is an important but tricky concern. Stress scenarios cannot fully take this into account as policymakers keep the official line that no country will be allowed to default. The least bad option is to disclose individual banks' country-by-country risk

exposures, as in July 2010 but with more reliable numbers. Alarming rumors that such disclosures would not be provided this year should be quickly dispelled.

Second, the process must ensure that the disclosures are fully trustworthy and comparable across countries. A common methodology is not enough. National authorities have powerful incentives to sugarcoat the results out of domestic political constraints and “financial nationalism”, the desire to favour or protect domestic players in the EU financial services marketplace. Last July there was no apparent second-guessing of the numbers coming from each member state, whose quality and reliability itself varied considerably from one country to another, and the clean bill of health given to Allied Irish Banks was enough to ruin the reputation of the entire exercise. The European Banking Authority (EBA), which coordinates the forthcoming process, is certainly aware of this flaw but it remains to be seen how it can be credibly addressed.

Third, there needs to be high-level political backing and readiness to address the consequences of the capital assessment whatever its results. This was most visibly absent last July, when it seems no member state would allow the stress test process to reveal bad news that was not already public knowledge. In other terms, policymakers must have a plan to restructure those banks that would be found undercapitalized and unable to raise the needed capital from market investors. The fledgling and understaffed EBA cannot reasonably be asked to take the lead on this task. Together with Adam Posen, now at the Bank of England, we advocated in mid-2009 that a temporary supranational public body should be purposefully created and given special authority to conduct the tough job of restructuring – a “European banking Treuhand”, by analogy with the agency that painfully but successfully restructured and privatised most of the industrial assets of the former German Democratic Republic in the early 1990s. This would however require a sense of purpose and of urgency that has not been much apparent among the key member states.

The bottom line is that the reasons that underpinned the failure of last year’s stress tests have not been removed and may well lead to a similarly disappointing result next June. If so, Europe’s policymakers would remain hostage to their zombie banks, including as regards the festering euro crisis. For the sake of Europe’s future, one can only hope that they quickly manage to change course and go for the process of genuine bank triage, recapitalization and restructuring that constitutes the only credible way of putting Europe’s financial system back on a sound track.

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