Europe's Stress Tests: Only One Step Toward Banking Repair

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The European banking "stress test" results announced on July 23 combined encouraging features with disappointing ones, which explains the paradoxical mix of reactions: markets rose, even as many analysts denounced what they saw as a sham. Their publication is unlikely to single-handedly bring the interbank market back to soundness. But it may prove an important step, depending on what policy initiatives come next.

On the plus side, there is unprecedented data on sovereign risk exposures, individually and consistently reported by all tested banks except one Greek and six German institutions. The wealth of information adequately addresses investors' biggest current concern. After having repeatedly called a sovereign default out of question, the authorities could not include one in their stress scenarios, but they have done the next best thing, as analysts can now do it in their place. Further good news is that, on first analysis, a Greek default would appear potentially manageable.

Also positive is that, for once, peer pressure has brought results. Spain effectively imposed transparency to reluctant fellow continental countries (the UK, Ireland and the Nordics were already ahead), apparently with substantial behind-the-scenes help from the European Central Bank, International Monetary Fund, and US Treasury. The whole process illustrates that some EU-wide systemic financial problems can only be addressed through EU-wide policy initiatives, a useful lesson for the future. Meanwhile, the Committee of European Banking Supervisors (CEBS) has proven its value added by steering the exercise within the imposed deadlines.

Sadly, bad news abounds too. The most obvious is the conclusion that only €3.5bn of additional equity would be sufficient to make Europe's banking system sound again. Few will find this credible, even allowing for the improved macroeconomic environment since the US stress tests of May 2009 had identified a $75bn capital shortfall. The tests' focus on Tier 1 capital, a questionable measure of strength, is also regrettable, and the argument that other ratios are insufficiently harmonized fails to convince. Supervisors should have tested core tier 1 under a more severe adverse scenario, to compensate for their assumption of no sovereign default. Furthermore, they should have provided more disaggregated information by asset class to shed light on risks other than sovereign. On these, the EU disclosure format is much less comprehensive than those used by the US last year, or by Spain on its own initiative.

The poor communication ahead of the disclosures is another negative. On 17 June, EU leaders rushed to the decision to publish test results without realizing that their end-July deadline was far too short given the complexity and diplomatic haggling involved. It would have been far better to set the deadline in September, and leave more time for coordination and preparation. Even after the deadline of July 23, 4pm GMT, CEBS could not make it clear that exposure to sovereign risk would be disclosed on a country-by-country basis, leading to unnecessarily negative first reports. This stands in stark contrast with the masterful channeling of market expectations by US authorities throughout late April and early May 2009.

Of perhaps more lasting concern is the absence of a clear commitment from the EU authorities to the data disclosed last Friday. Both CEBS and the ECB made it clear that the capital assessment belonged to individual national authorities. Respect for member states' sovereignty is understandable, but it means that nobody actually stands for the full set of disclosed numbers.

Last but not least, Germany appears still in denial about its domestic banking crisis. Beyond the legal arguments, German authorities dragged their feet, resisted the call for disclosure, and eventually failed to deliver the full numbers provided by almost all others. Behind the bureaucratic inertia lies a deeper political quandary: German leaders have made too many proclamations of Teutonic virtue against shadowy Anglo-Saxon speculators and profligate Southerners to recognize that there is rot in the middle of their very own banking system, which incidentally happens to be uniquely interdependent with local party elites, left and right. As long as Chancellor Angela Merkel and her team do not amend this stance, Europe is unlikely to get rid of its lingering financial fragility.

Ultimately, history's verdict will depend on what happens now. First, Europe's banks still need to raise more capital, and authorities must find a way to encourage this even after having ostensibly given them a clean bill of health. The trigger for the publication was the eurozone sovereign crisis, and the aim remains to make the banking sector resilient enough to sustain a possible future public debt restructuring. Second, fragile eurozone countries must continue their efforts towards sustainable fiscal consolidation, so that if one eventually defaults, others can resist the contagion pressure. Third, it is crucial for the EU to replace the fledgling CEBS and similar committees on insurance and securities with more authoritative European Supervisory Authorities, as recommended last year by the Larosière Report. It would be disastrous if the ongoing discussions ended in stalemate. But, should adequate progress be made along these three dimensions, then the publication of stress test results may be judged to have been a success after all.

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