The European Union Has Not Yet Solved Its Banking Problem

By Nicolas Veron

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The chaos that followed Lehman Brothers' collapse two years ago hit financial systems in the US and Europe with similar violence. But the consequences were not symmetrical. Several large financial institutions disappeared in the US, partly because of stringent disclosure requirements, leading to immediate restructuring of the financial landscape. In the spring of 2009, public "stress tests" forced weaker banks to recapitalize, and soon the institutions at the core of the US financial system started regaining investors' confidence, in spite of much pain still to come among smaller local banks. The US faces major economic and social challenges, but its financial crisis appears to have essentially ended more than a year ago.

By contrast, the European Union collectively met the challenge with a succession of false hopes. It first seemed European banks could ride the trust wave initiated by the US stress tests. Share prices went up, and some banks took advantage to raise significant amounts of equity – however, these were typically the stronger ones, not the damaged institutions that most needed new capital. European supervisors conducted stress tests of their own in September 2009, but these had little impact as almost none of their results were made public.

The lingering fragility of Europe's banks became impossible to hide when the Greek fiscal crisis unfolded in early 2010. Policymakers eventually realized that their banking systems were too weak to withstand the impact of a Greek default. This is now widely acknowledged to have been a major driver of the decision to bail out the Greek state and then to establish a large funding facility for all euro area countries.

In a fit of decisiveness, Europe's leaders agreed in June 2010 to disclose the results of the next round of stress tests. The data published on July 23 represented progress of sorts: the small London-based staff that coordinated the process managed to persuade almost all 91 banks tested to publish details of their sovereign risk exposure, and Spain voluntarily provided additional transparency. Once again, at first it seemed to work, and initial market reaction was cautiously positive. But serious flaws became quickly apparent. The numbers, left at the discretion of national authorities that could be tempted to sugarcoat the situation, were not double-checked or audited. The chosen yardstick of capital strength, "tier-one" capital, was questionable. Some underlying profit forecasts were probably overoptimistic. Apart from Spain, specific exposures to risks other than sovereign went unreported. The stress tests' bottom line, that 3.5 billion euros would be enough to adequately recapitalize the system, was not plausible.

Later developments further undermined confidence. On September 7, the Wall Street Journal pointed to serious inconsistencies between the stress test results and sovereign risk exposures separately published by the Bank for International Settlements in Basel, based on data provided by the same national authorities that conducted the tests. Policymakers claimed that there were technical reasons for the discrepancies but failed to explain them in a manner that would reassure investors. A few weeks

later, the multi-billion-euro public bail-out of Allied Irish Banks, which had successfully passed the stress test in July, made the whole process a laughing matter.

Most importantly, the stress tests have failed to trigger the needed recapitalization and restructuring of Europe's problem banks. Just as in 2009, those banks that recently raised fresh equity, such as Deutsche Bank or Standard Chartered, were among the stronger rather than the weaker ones. In Germany, some state-controlled Landesbanken are universally considered unviable, but their restructuring advances at a glacial pace. Jürgen Stark, an executive board member of the European Central Bank, was recently reported to have claimed that the much larger German savings banks sector was itself generally undercapitalized. In Spain, the central bank has engineered mergers among savings banks but it is not yet clear that the resulting entities are strong enough. In several countries, the authorities' aim still appears to be to hide the bad news rather than to fix the problems.

The probable consequence of this paralysis is a substantial drag on growth, as in Japan's "lost decade." Moreover, in the event of further turmoil on the sovereign front, the EU could find itself confronted with the exact same banking fragility that so severely restricted policy options this spring. What is needed remains unchanged: a triage process that credibly identifies capital gaps among Europe's most important financial institutions, and leads to adequate recapitalization and restructuring. The good news is that the creation of a European Banking Authority, due in January 2011, in principle provides a possible basis for a centralized EU-wide assessment process. But it is not enough. A solution to the EU's banking problem would require a level of awareness and political commitment that has been sadly absent so far, especially in the largest euro area countries.

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