European Bank Stress Tests: Third Time Lucky?

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Systemic bank crises are always difficult to resolve. In Europe, the difficulty is compounded by cross-border interdependencies. Policy paralysis throughout 2009 and 2010 has resulted in a banking system precariousness that puts a serious drag on the old continent's recovery. An even more dramatic consequence is to force the euro zone to systematically choose bail-outs over restructurings, whenever one of its members faces macroeconomic difficulties.

In April, there was a strong case for immediate sovereign debt restructuring rather than saddling Greece with unsustainable debt levels. But the resulting shockwaves might have toppled fragile Western European banks and gone out of control. Greece's bail-out was chosen as the least bad option. Similarly, many voices in November called for imposing losses on Irish banks' senior debt. But this might have impaired the ability to borrow for European banks whose balance-sheet strength is questionable, possibly causing a panic. Thus, bailing out senior bank debt was a big part of the Irish assistance package. Those decisions may have been inevitable in their respective circumstances. But their outcome is gross unfairness, as well as the precipitation of a debate on eurozone solidarity and fiscal federalism for which the European Union may not be politically ready. The major policy failure is the absence of firm action in calmer times to make the system more resilient.

Systemic banking crises are almost never self-correcting: even with low central-bank rates, retained earnings cannot plug all holes after a major shock. What is needed is a government-led process of ruthless triage, recapitalization, and restructuring of the system's most important banks. This approach was pursued by the US in 1989-90 following the savings-and-loan crisis, Sweden in 1992-93, Japan in 2002-03, and again the US with its 2009 stress tests. The EU has not yet done anything comparable. A first round of Europe-wide stress tests in September 2009 went virtually unnoticed as the results were not made public. A much-hyped second round included public disclosures in July 2010, but ultimately failed to restore confidence. Now a third round is forthcoming in February 2011. European Commissioner Olli Rehn announced it will be "even more rigorous and even more comprehensive." But the design flaws of the previous attempts must first be fixed for this to succeed. History suggests three components are essential.

First, triage: a public assessment of the real capital position of all important institutions in the system, on the basis of an intrusive, uniformly stringent review of assets and liabilities, because financial statements are unreliable in crisis times. Large cross-border financial linkages mean it must be Europe-wide. Last July, triage failed when each member state implemented the commonly defined methodology its own way. As national authorities cannot be trusted to place the EU common interest before their own, a central body must be empowered to double-check national assessments and make sure they are genuinely comparable.

Second, recapitalization: banks that have been found too weak must raise new capital. As last time, the next stress tests's public results are likely to underestimate capital gaps, because EU policymakers cannot explicitly include sovereign default in a stress scenario for fear of this assumption becoming self-fulfilling. To compensate for this unavoidable flaw, policymakers should toughen other stress assumptions and impose a high threshold of a strict measure of capital, rather than the loosely defined "Tier-1" tested last July. They must add extensive disclosure of each institution's sovereign risk exposure, with better explanation than in July of how to reconcile such numbers with otherwise published financial statements and with the Bank for International Settlements' statistics.

Third, restructuring. Unlike in the US in 2009, some banks may fail to raise the needed capital. Such banks must be either forcibly sold, or orderly dismantled. This process must also be steered centrally to ensure fairness and efficiency. Potential difficulties abound. Banks that are widely seen as "national champions" may be acquired by foreign competitors. Jobs may be destroyed, in the banks and also in the non-financial companies they support. National authorities may be pilloried for their past failures to act and their links to failed financial elites. New legislation may be needed, with all the related uncertainties. Specifically, the newly created European Banking Authority may not have what it takes for such a tough job, and it might be preferable to create a temporary body specifically dedicated to crisis resolution. Public funds may have to be committed in significant amounts, to meet legal obligations and avoid dangerous contagion. Negotiations may be needed on sharing the burden among countries, and on possible cross-border assistance as in the Irish case.

All this can be very disruptive. But the alternative is a policy process held hostage by a sick banking system, and ever larger commitments of taxpayers' money that may threaten the very political fabric of the EU.

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