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Fiscal Competition & Economic Freedom

INSTITUTE FOR RESEARCH IN ECONOMIC AND FISCAL ISSUES

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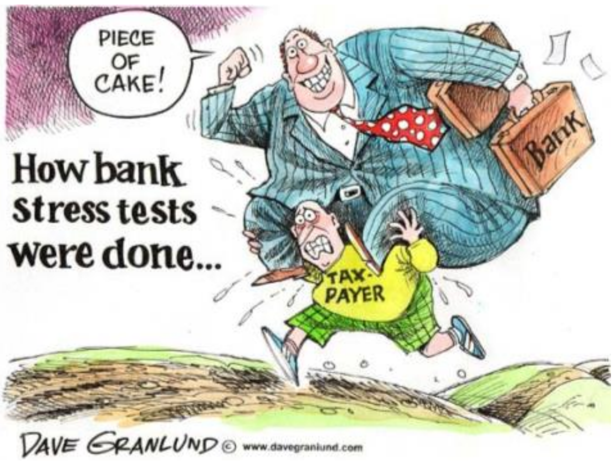
New Bank Test says "Everything OK". Again...
But we read between the lines.

by Gordon Kerr and John Butler, with Enrico Colombatto

The Asset Quality Review (Stress Test) results confirm system wide solvency. Yet, regulators announce the rewriting of bank risk models and the ECB plans large scale asset purchases.



At the end of October, Europe's new Supervisory Board for banking (ESB) announced the results of its review of the largest 130 banks, accounting for 82% of the Eurozone's banking assets.

The report was received positively, if rather quietly, by mainstream media. Markets hardly reacted, implying that the report contained no surprises. Some commentators raised the odd eyebrow at, for example, the 100% "pass rate" of the German banks, despite the fact that Deutsche Bank's problems forced it to demand €8.5 billion in cash by diluting shareholders as recently as June.

We regard these benign stress test results as virtually meaningless and we are not alone. Why is such scepticism so widespread? Let us first briefly review the history.

(continued on page 2)

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History of European Stress Tests

Test 1: 2009

The first Europe-wide tests were implemented by the Committee of European Banking Supervisors (CEBS) in 2009. Their aim was to measure banks' abilities to withstand a downside scenario against a minimum target Tier 1 capital to risk-weighted assets ratio of 6 percent. The results announced on October 1, 2009 suggested that none of the 22 large banks in the sample would see their Tier 1 ratio fall below 6 percent in the adverse scenario. All 22 passed with flying colours. The CEBS press release proudly talked of how the "resilience" of the banking system reflected the success of recent public-sector support of banks.

Test 2: 2010

In 2010 another stress test exercise was announced, this time encompassing 91 banks and covering 65% of European bank assets. The results announced on 23 July 2010 were extremely positive, only 7 banks failed to maintain a minimum of 6% core Tier 1 capital to assets ratio, and the aggregate shortfall of these 7 was only €3.5 billion.

Critics of these tests pointed out that they assumed no losses or disruptions to cashflows from sovereign debt, and that at the end of 2009 the combined sovereign debt of Portugal, Ireland Greece and Spain was €2.8 trillion. This concern was dismissed on the ground that the EU would not let any sovereign fail, a resolve that was quickly tested when on November 21st 2010 the Irish Government announced that its national banking system, which had collapsed and been 100% guaranteed by its sovereign in 2008, had now bankrupted the government. An EU bailout of the Irish government was quickly arranged.

Test 3: 2011

Because this event so obviously undermined the earlier stress tests, a new and harsher round of testing was announced a few days later. This was conducted by a new institution, the European Banking Authority, using a stricter test of capital – 5% core Tier 1 instead of 6% Tier 1 (ie core plus noncore – the 'non-core' now officially regarded as an unreliable measure). The tests still ignored the risk of sovereign default, and produced an even less credible result. The 90 banks tested revealed a combined capital shortfall of €2.5 billion. Three months later the large Franco-Belgian bank Dexia failed. Moody's rating agency had pointed out that the 5% core Tier 1 equity test was even weaker than the Basel 3 standard of 7%, and estimated that had that threshold been applied more than half of the banks tested would have failed.

Stung by this criticism, the EBA engaged in wordplay in the fall of 2011. It attempted to justify a new shortfall estimate of €114 billion (45 times the earlier estimate) on the ground that "barriers" were needed for possible "shocks". Of course, they meant "buffer" but used the term "barrier", perhaps for fear of being accused of having manipulated the test. But then, what were the official results of the stress tests meant to recommend? The IMF separately published a capital shortfall estimate for these banks of €200 billion at about the same time. Almost double the EBA estimate.

Test 4: 2014

The next major event was the failure of the Cypriot banking system in March 2013, despite the fact that its two major banks had previously passed all iterations of the tests. This episode spurred the assessment exercise about which we now write, but perhaps the most significant feature of the latest exercise is the length of time it has taken: 12 months. This adds some veneer of respectability, and the ESB has put its PR machine on overdrive to persuade everyone of its worth.

Why The Latest Stress Tests Are Different — according to ESB...

The ESB's own communiqués emphasise **3 REASONS** why its "Asset Quality Review" (AQR) should be respected.

A) We now have a Single European Supervisor – An Historic Event

Europe-wide centralized supervision is the first of three 'pillars' of the banking union, itself described as 'the biggest undertaking of the European Union since the introduction of the euro'. (This statement appears to have been crafted with no apparent irony, as if to imply that the size outweighs the odd hiccup, such as the sovereign debt crisis one of whose fundamental causes is now universally recognised as the introduction of the euro.)

B) Assessment Standards are now uniform

"The...asset quality review for the first time applied uniform standards for valuing bank assets and accounting for potential problems such as non-performing loans."

Well, on the face of it, 'universal valuation standards' sounds positive. But should it? Surely it stretches belief to suggest that the absence of universal evaluation standards was a significant cause of systemic bank failure in 2008. Non-performing loans were nowhere near the top of the list of official factors triggering the big freeze. The establishment view has always been that there never was anything fundamentally wrong with bank accounting. The main focus of the critics of bank accounts was twofold; **a)** which balance sheet items should count as capital, and **b)** tightening of rules relating to off balance sheet exposures to bring them on balance sheet.

The dominant explanation from all sides of the political divide was that harsher regulation was needed to curtail taxpayer and depositor exposure to casino banking and excessive risk taking. This meant that, when US home prices dipped, the scale of residential mortgage securitisation risks assumed by the financial sector caused either a liquidity crisis as confidence wobbled, or in some cases insolvency. The Volcker Rule has been the main response to this concern, which we reported in January.

C) Bank Risk Models – The ESB has Reviewed and Changed

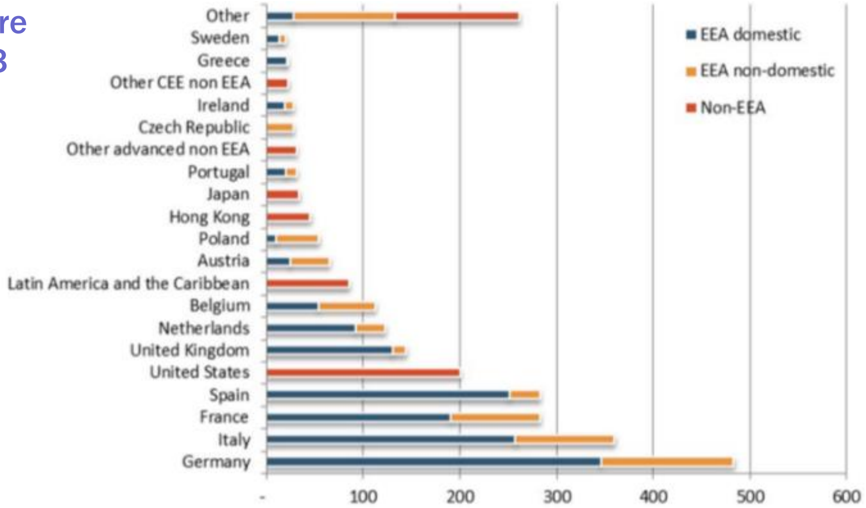
Readers will remember that one of the most important regulatory changes incepting in 2008 was that large banks self-assess the capital to be allocated to each of their assets. The ESB was concerned that "some banks' calculations of the capital requirements were "too low", and expressed further concern about data inputs used for modelling. Given that a single bank asset's risk model is often the size of an airport runway, it is hard to believe that the ESB can really have reviewed much of the aggregate system wide modelling volume even in an exercise spanning 18 months.

Direct net sovereign exposure (bn €) as of December 2013

The graph (from the Stress Test Report) shows for individual countries their net exposure to governments' debt through European domestic (blue) and non-domestic banks (yellow) or through other banks sovereign debt.

More than half of direct sovereign exposure is held by domestic banks.

Germany and Italy together account for over 30% of exposure.

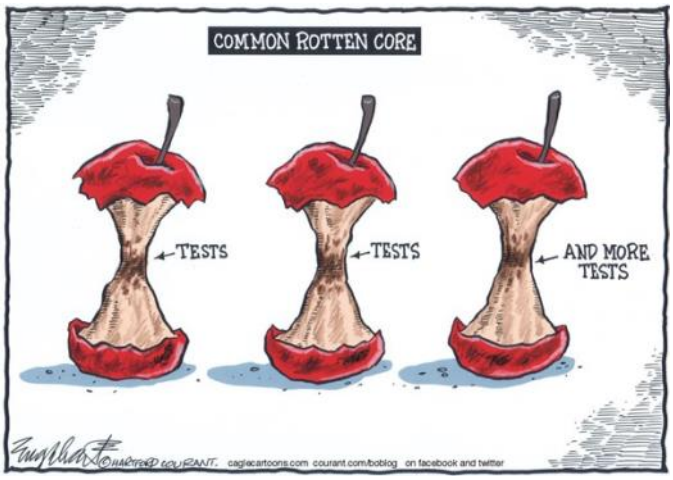


What the reports are really telling us

Nonetheless, we would contend that these press communiqués, more so than the official AQR results, are the most accurate indication of the health of the Eurozone's banking system; it is insolvent. When regulators are reduced to changing risk models, the problems are always serious. Model changes preceded the eruption of the JP Morgan 'whale' trades in early 2012, whose ensuing losses amounted to 100 times the capital which the models claimed the risks required.

Eurozone's banking system is insolvent. When regulators are reduced to changing risk models, the problems are always serious

Furthermore, according to the Financial Supervisory Board (overseers of the Basel rules) risk based capital models were of zero use in predicting systemic failure in 2008, hence their drive for a new standard, the Leverage Ratio which we reported on in December 2013. No Leverage Ratio was featured in the ESB's tests.



Postponing the inevitable?

We conclude that there is no reason to have any greater confidence in these latest test results, despite their historic uniqueness, uniformity of assessment standards and increased focus on risk models. However, please relax. The system is unlikely to tilt over again any time soon, because the European Central Bank has just announced that it stands ready to launch into large scale (up to €1trillion) purchases of banks holdings of private sector assets and sovereign bonds. That should boost prices and prop up bank balance sheets for a while.

Relax. The system is unlikely to tilt over again any time soon.

Unsurprisingly, this news has provoked a degree of internal rancour at the ECB, since the opponents of asset purchases are increasingly worried about the Ponzi nature of the ECB buying these assets to maintain the fiction of bank solvency. As reported by Reuters, as many as seven national central banks now oppose these asset purchase plans. This simmering situation may warm up in time for our December issue. Stay tuned.

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