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The Bank for International Settlements (BIS) reports the "Failure to Come to Grips with Financial Booms and Busts"

by Gordon Kerr and John Butler, with Enrico Colombatto

Ultra Low Interest Rates have destabilized the global Economy whose capital markets now show signs of Illiquidity.

The 85th Annual Report of the BIS pulls no punches.

"Persistent exceptionally low rates reflect the central banks' and market participants' response to the unusually weak post-crisis recovery as they fumble in the dark in search of new certainties."

Interest rates have been low for an "extraordinary" period of time, leading to "unbalanced" economic expansion, and levels of debt and financial risk which are "too high". Policymakers have backed themselves into a hole; the "room for manoeuvre in macroeconomic policy is too limited". In short, BIS economists Claudio Borio and

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Are European Banks in Better Shape? Should Reliance be Placed on Stress Tests?

by Gordon Kerr and John Butler, with Enrico Colombatto

Stress testing of banks by central banking authorities has come to prominence as reliance on the traditional accounting standards has waned. Europe's banking system was successfully stress tested last October, but we were not impressed. In December, the UK banking system was declared safe and sound, but in June a detailed analysis of those tests described them as "fatally flawed".

The report, written by Professor Kevin Dowd, argues that the December 2014 test results are "worse than useless" because the Bank of England (B of E) set the pass mark "too low for minimum capital requirements and left itself open to banks manipulating their risk-weighting models". The report claims that the B of E is "sleep-walking" the banking sector into another financial crisis. In response, the Bank declined to comment but pointed to evidence given by B of E official Alex Brazier to the UK Parliament's Treasury Select Committee, in which he described the programme of tests as "really tough" and "a big step forward for macro prudential policy". Who is to be believed?

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(cont'd) ... Financial Booms and Busts

Jaime Caruana repeat the message we reported in Newsletter last July that central banks have pushed interest rates so low that they are now "defenceless" in the face of any future recession. Specifically, the BIS emphasise the circular policy paradox whereby the lowering of interest rates has resulted in asset price bubbles, to which the policy response has been even lower interest rates and/or quantitative easing. Despite the much reported deflation fears, in a separate publication the BIS reported that house prices in 2014 increased on average by 3-5% throughout the EU, including by 10% in Sweden and Britain, although they declined in Greece by 4%.

The BIS' warnings about low interest rates are well known and not new. Less widely reported is its recent focus on the sharp reduction in bond market liquidity. According to the same report, as banks have deleveraged, the asset management industry has become the dominant player in the US bond market, with 20 firms holding 40% of this entire market. Liquidity has dropped markedly; the proportion of securities that trade regularly in the U.S. fell to less than 5 percent from 20 percent during this period. The BIS sees signs that liquidity tends to dry up when asset managers most need it to meet investor redemptions. (This confirms our observations about declining liquidity in secondary capital markets.) This dynamic is by no means confined to the US; the Bank of Japan and the ECB are presently buying up the equivalent of US$ 120 billion per month under their quantitative easing programmes. Of course these purchases are funded by cash, but that cash tends to make its way back on to the books of central banks as net commercial bank lending has barely grown, especially in Europe (BIS Report p 53).

Sustained ultra-low interest rates have created asset price bubbles, which have drained liquidity despite, indeed in tandem with, quantitative easing.

So, sustained ultra-low interest rates have created asset price bubbles, which have drained liquidity despite, indeed in tandem with, quantitative easing. This may explain why the supposedly trivial Greek economy has taken centre stage. In an illiquid, interconnected global market, even a small credit event can trigger large contagion effects. As the standoff continues, Europe's media unites behind the message that Greece is in big trouble unless it can cut a deal to reopen its banks and remain part of the Eurozone, because Europe's financial system is on the road to recovery. But is it?

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(cont'd) How reliant are Stress Tests?

We say these stress test results are discredited on five separate counts.

❶ The first concern relates to the stress scenario itself. Note the singular term, despite the B of E's prior discussion paper emphasising the importance of using multiple scenarios:

"A key principle underlying the Bank's approach to stress testing is to explore a range of scenarios".

It is not possible to infer confidence in the system from any single scenario, yet the B of E ignored this principle. Moreover, the scenario adopted does not seem particularly severe; UK unemployment up to 12% (the present European average); interest rates up by 4% (still below pre-crisis levels); house prices down by 35% (they have more than doubled since the crisis).

❷ The second concern is testing against unreliable Risk Weighted Assets (RWAs). As we recently observed in the context of US stress tests the B of E successfully lobbied for the global introduction of a Leverage Ratio because its own analysis showed that RWAs indicated falling exposures before the crisis, whereas a leverage test would have shown the opposite. The B of E itself concluded that low RWAs simply show that banks have hidden their risks, not that risks have reduced.

❸ Thirdly, there is an inherent credibility problem, because no central bank can admit there are major problems in its banking system without undermining it - and indeed, none has ever conducted a stress test with a damning conclusion.

❹ Fourthly, the process of risk model standardisation inevitably creates systemic risk - moreover, a systemic risk to which the models are blind.

❺ But the most alarming revelation of Dowd's report is that the B of E deliberately misled Parliament by ignoring three of the four components of the minimum capital requirement according to globally accepted Financial Stability Board (FSB) rules. In other words, the tests failed to use the FSB minimum amounts of "Core Equity Tier 1" (CET1) to RWA; had these minima been applied, all 8 banks tested would have failed.

The four components of CET1 are:

i) A base minimum of 4.5%
ii) A 'point buffer' of 2.5%
iii) A 'Counter Cyclical Buffer' (CCB) of up to 2.5%
iv) A 'Systemically Important Financial Institution' Buffer of up to 2.5%

i) is the traditional starting base minimum; ii) an added amount post crisis recognising that 4.5% was too low; iii) an additional amount given the state of the business cycle to which the relevant bank is exposed; iv) a further addition for banks deemed 'too big to fail' ('SIFI's). The last two components are at the dis-

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(cont'd) How reliant are Stress Tests?

cretion of the national central bank. Both were set to zero in December 2014, despite the B of E publishing SIFI buffers ranging from 1% to 2.5% for the UK's 4 biggest banks two months later, thus gaming the calendar of its own regulation. The point buffer (ii) was simply ignored.

In this way the pass mark, the minimum ratio of capital to RWA which each bank must show surviving the stress test, was set at 4.5% for each of the 8 UK banks, rather than the absolute minimum of 7 % (the sum of (i) and ii)). An impartial central bank would have used 11–12%. This is akin to a school administering national examinations for its pupils and reporting healthy results by stealthily using a pass mark of 20% instead of the mandated 50%. Given that all 8 banks clearly fell well short of the pass mark in a moderate recession scenario, with tests based on their RWAs, we conclude that the B of E publication demonstrates that UK banking is overleveraged and deeply insolvent.

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Leverage is the opposite side of the liquidity coin. This perhaps explains why the BIS is so worried, and why Europe's leaders seek a fudge over Greece.

- With a zero CCB, every bank but Santander and Standard Chartered would have failed, and latter would have passed by a whisker (8.1% against a minimum hurdle of 8%).
- With the CCB set to its potential maximum (2.5%) to produce a more rigorous and more credible test, then every single bank would have easily failed.

TABLE 2: RESULTS OF THE STRESS TEST AGAINST THE BASEL CET1/RWA HURDLE RATIO

BANK	PROJECTED CET1/RWA	HURDLE RATIO		PROJECTED MINUS HURDLE	
		CCB=0	CCB=2.5%	CCB=0	CCB=2.5%
Barclays	7.5%	9%	11.5%	-1.5%	-4%
Co-op	-2.6%	7%	9.5%	-9.6%	-12.1%
HSBC	8.7%	9.5%	12.0%	-0.8%	-3.3%
Lloyds	5.3%	7%	9.5%	-1.7%	-4.2%
Nationwide	6.7%	7%	9.5%	-0.3%	-2.8%
RBS	5.2%	8.5%	11.0%	-3.3%	-5.8%
Santander	7.9%	7%	9.5%	0.9%	-1.6%
St. Chartered	8.1%	8%	10.5%	0.1%	-2.4%

Source: "No Stress" by K. Dowd, Adam Smith Institute 2015

Conclusion - Greece's standoff in the context of a highly leveraged, illiquid Financial System.

Greece's creditors never speak about systemic leverage, ultra low interest rates or levels of financial risk. Nobody from the EU, the ECB or the Eurogroup (the Finance Ministers of the other 18 Eurozone nations) refer to the views of the BIS, despite the standoff being acknowledged by all creditors as of structural importance for Europe if not elsewhere.

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One possible explanation is that the creditors privately fear that in illiquid markets dominated by overleveraged SIFI banks, the failure to sign another "pretend and extend" agreement may trigger a significant credit event. This could explain why debt forgiveness remains on the table after the agreement of July 13. "Restructuring" is merely the diplomatic term for "forgiveness". This debate continues despite strong opposition from prominent analysts. Professor H-W Sinn of Germany's CESifo Institute opines that Greece is insolvent, that Germany's loans are already lost, and that the clever Greek negotiators are simply showing up at these meetings because it has never been easier to obtain free cash. The ECB's Emergency Liquidity Assistance ('ELA') facilities constitute cash. Restructuring agreements merely amend the marked to market position of illiquid debt instruments. In the present climate of financial markets, such accounting may keep the markets calm. But then again, it may not.

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