Striking a healthy balance

Thorsten Beck analyses the results of the ECB's recent health check on 130 of the biggest eurozone banks and says more steps must be taken if banking union is to be established

October 26 was the climax of a year-long process, one that involved more than 6,000 ECB staff and consultants going through the books of the 130 largest banks in the eurozone to check that they were sound. The ECB adjusted non-performance exposures and asset values and subjected banks' balance sheets and capital positions to a stress test. Put plainly, it looked to see how many of the loans on their books were bad and whether, given another crisis, banks could absorb the shock without recourse to a taxpayer-funded bailout.

This health check, referred to as the Comprehensive Assessment, was also to make sure that the banks were all fit to undergo direct supervision by the ECB, which began on November 4, under the new Single Supervisory Mechanism (SSM). (It should be noted that the European Banking Authority (EBA) also undertook stress tests for banks in non-Euro countries, which all four participating 4 UK banks passed. In addition, the Bank of England conducts its own stress tests, with UK specific scenarios referring to housing market and interest rate shocks, the results of which are due by the end of 2014.)

The 130 banks that underwent the Comprehensive Assessement are the backbone of the eurozone banking system, with total assets of €22tn and 81.6 per cent of total banking assets in the countries of the SSM. The banks were chosen either by size (more than €30bn in assets), importance relative to the home country's GDP (more than 20 per cent by asset base, unless this was below €5bn) or market position (among the largest three institutions in the respective country).

The story so far

It is not the first time that European banks have been subjected to a stress test. The previous stress tests (undertaken in 2009, 2010 and 2011) were criticised, however, for not having identified problems in banks' balance sheets and for using unrealistic stress scenarios. That is why the Comprehensive Assessment was set up to be quite different from these previous rounds. First, the stress test was combined with an asset quality review, with the aim of setting up a proper base on which to compare the outcome of the stress test. Second, the exercise was centrally led by the ECB rather than relying on national authorities.

How does the exercise compare with similar exercises elsewhere? Observers like to compare the European approach with that in the US. In 2009, shortly after the Lehman Brothers shock, US authorities decided to subject the 19 largest US banks to a stress test and to publish the results. In addition, the 10 banks found, on the basis of the test, to have a capital shortfall were forced to recapitalise through the markets or to take on government funding.

European policy makers took a different approach to their banks post-crisis. While many European countries promptly intervened in failing banks in their own jurisdictions and, in most cases, bailed them out, there was no broader attempt to assess the health of the European banking system. This piecemeal approach might have been partly driven by the weak fiscal position of many European sovereigns and partly by the fact that any additional bailout could not – unlike in the US – be monetised through a central bank. In addition, the first years after the Lehman collapse saw a "bunker" approach where nations focused purely on their own banks' fragility.

> The asset quality review was the starting point for a subsequent stress test

The state aid examinations by DG Competition of the European Commission – intended to ensure that competition was not being distorted by bailouts and that these were undertaken only as emergency measures with the overarching aim of financial stability – were the only indirect coordination mechanism.

What is the Comprehensive Assessment?

The Comprehensive Assessment consisted of two parts, discussed in more detail below. First, there was the asset quality review, an assessment of banks' asset positions as per December 31, 2013. Second, there was a forward-looking stress test to gauge how banks' capital position would develop under two alternative scenarios.

As described by the ECB, the exercise had the objectives of:

- identifying any necessary repairs and implementing remedial actions vis-à-vis weak banks;
- creating transparency on the banks' condition;
- building confidence.

Obviously, these three objectives are closely linked. The weak confidence of markets in the solvency and resilience of European banks is due to the (perceived) lack of transparency of their balance sheets and the potential for "skeletons in the closet".

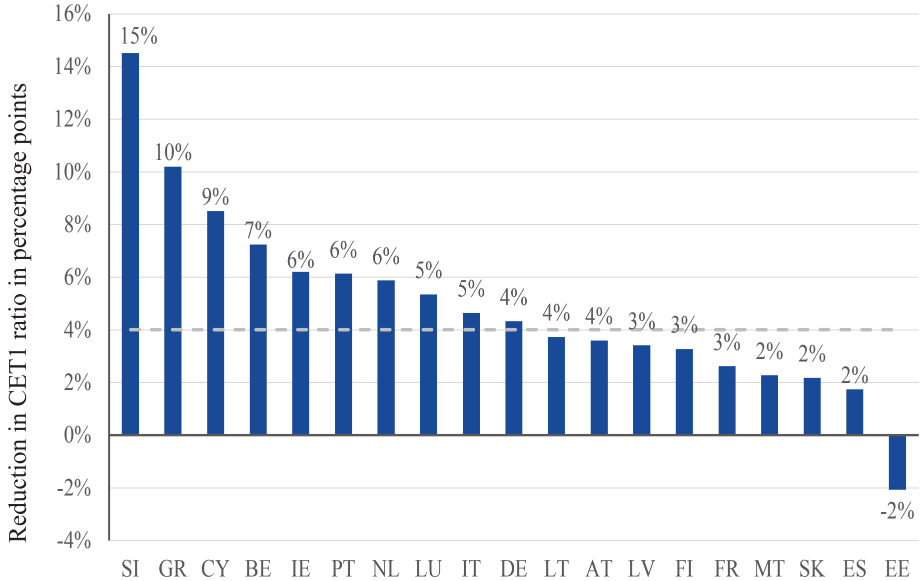
Asset quality review

The asset quality review (AQR) was an assessment of the accuracy of the valuation of banks' assets and the starting point for a subsequent stress test. It was undertaken by the ECB and national supervisory authorities, based on a uniform methodology and harmonised definitions, including areas that can leave banks and auditors quite a bit of room for manoeuvre, such as collateral valuations, forbearance and non-performing exposures. The important role of the AQR in the context of the Comprehensive Assessment is unique in the light of exercises undertaken in other jurisdictions, but is necessary given the large discrepancies in accounting norms across countries within the eurozone. The objective was to create a level playing field both for the stress tests and entry into the SSM.

The analysis undertaken in the AQRs was not superficial. To give one example, a detailed review of more than 800 specific loan portfolios, making up 57 per cent of the banks' risk-weighted assets, was undertaken. This involved a detailed analysis of more than 119,000 borrowers and the assessment of the valuation of about 170,000 collateral items.

The AQR revealed that, on average, banks' internal definitions of non-performing exposures (NPE) were looser than that of the ECB, with adjustments in provisions concentrated among real-estate-related and shipping assets, and primarily in central Europe and the Mediterranean. There is also an important cross-country variation. While the total adjustment amounted to 13 per cent in risk-weighted assets in Greece, it amounted to less than 1 per cent in Spain. This most likely reflects differences in previous efforts to restructure and recapitalise banking systems in some of the countries as much as differences in banking fragility and regulatory forbearance.

Median projected adverse scenario reduction in capital ratio by country of participating bank



Source: ECB, Aggregate Report on the Comprehensive Assessment. *Free at:*
www.bankingsupervision.europa.eu/ecb/pub/pdf/aggregatereportonthecomprehensiveassessment201410.en.pdf

The results of the asset quality review led to an adjustment of capital positions as banks brought their estimation of the value of their assets into line with the ECB definition. On the basis of the Capital Requirements Regulation and Directive (CRR/CRD IV), banks were required to have a common equity tier 1 ratio (CET1) relative to risk-weighted assets of at least 8 per cent. CET1 capital is the bank funding that will be first in line for losses if the institution gets into trouble – predominantly common shares with the remainder made up of debt instruments that are subordinated (ie far down the pecking order for redemption) and that have fully-discretionary, non-cumulative, dividends or coupons and neither a maturity date, nor an incentive to redeem.

Stress test

A stress test is a forward-looking exercise to gauge the resilience of banks' solvency in the face of adverse economic scenarios. Stress tests are a central part of the IMF's Financial Sector Assessment Program (FSAP), introduced after the east Asian crisis. Typical scenarios include sharp changes in market prices (eg interest rates), liquidity shocks or economic shocks. The stress test in the Comprehensive Assessment was undertaken by the participating banks, the ECB and national competent authorities (NCAs), in cooperation with the European Banking Authority (EBA), which also designed the methodology in tandem with the ECB and the European Systemic Risk Board (ESRB). Banks were considered to have a capital shortfall if, under the adverse scenario, they had a CET1 ratio of less than 5.5 per cent.

> Most of the 130 banks hold excess capital above regulatory requirements

The time horizon for the stress test was for three years, 2014 to 2016. Two scenarios were used in the stress test, with the baseline scenarios based on the official macroeconomic forecasts by the European Commission and the adverse scenario, provided by the ESRB, based on deviations in GDP from the baseline by -1.9 per cent, -5.1 per cent and -6.6 per cent for 2014, 2015 and 2016, respectively. These numbers are the results of a scenario that includes several negative shocks, including an increase in global bond yields, further deterioration of credit quality, stalling policy reforms and the lack of necessary bank restructuring and recapitalisation.

The stress test included:

- credit risk, ie default risk of loans and securities;
- market risk stemming from changes in market prices;
- interest rate risk, ie losses stemming from adverse movements in interest rates;
- sovereign risk, ie higher borrowing costs due to rating downgrades; and
- securitisation risks, ie losses resulting from ratings downgrades.

There is also an important interaction between AQR and the stress tests. If the AQR shows an underestimate of NPE, the stress tests could result in an overestimate of the bank's exposure to adverse changes. The ECB took into account these interaction effects with a "joined-up" approach.

On the basis of this, combining AQR and stress test with the adverse scenario, the banks' aggregate available capital is projected to be depleted by €215.5bn by 2016 (this is 22 per cent of the capital held by participating banks). At the same time, risk weighted assets (RWA) are set to increase by about €860bn because of higher risk weights. In total, the negative capital impact is €262.7bn in the adverse scenario.

What this means for the banks is that there will be a fall in CET1 ratio for the median participating bank of four percentage points from 12.4 per cent to 8.3 per cent by 2016.

Behind this median, however, there are important differences across countries. While the decrease is 15 per cent in the participating Slovenian banks and 10 per cent in the Greek banks, it is only 2 per cent in banks in Malta, Slovakia and Spain. Estonia will actually see a boost of 2 per cent in the CET1 ratio at its banks.

Given that most of the 130 banks hold excess capital above the regulatory requirements, the capital shortfall after the Comprehensive Assessment was €24.6bn, €10.7bn of which stems from adjustments made under the AQR and €11.2bn from the stress test, with the remainder from the joined-up exercise mentioned above.

The final outcome

Overall, the Comprehensive Assessment identified a capital shortfall of €24.6bn across 25 participating banks after comparing their projected solvency ratios against the thresholds defined for the exercise. While this seems a rather low number of potentially undercapitalised banks, compared with alternative estimates, there is a high variation across countries. The capital shortfall is more than 6 percentage points of banks' risk-weighted assets in Cyprus, but zero in most countries.

The geographic location of banks with capital shortfalls identified under the Comprehensive Assessment is also uneven, with nine banks from Italy, three from Greece and Cyprus each, two banks in Belgium and Slovenia each, and one bank in Spain, France, Germany, Ireland, Austria and Portugal. Most of the capital shortfall is concentrated in smaller banks, while none of the global SIFIs (systemically important financial institutions) located in Europe failed the review.

However, the aggregate shortfall of €24.6bn does not take into account the €57.1bn in capital that has been raised by the participating banks in the eurozone since January 1, 2014. Once this has been added to the tally, only 13 banks still face a net capital shortfall, which totals €9.5bn, a modest number. Among these 13 banks, four are in Italy, three in Greece, two in Slovenia, one in Portugal, one in Austria, one in Ireland and one in Belgium. So, there is again a certain concentration in crisis countries.

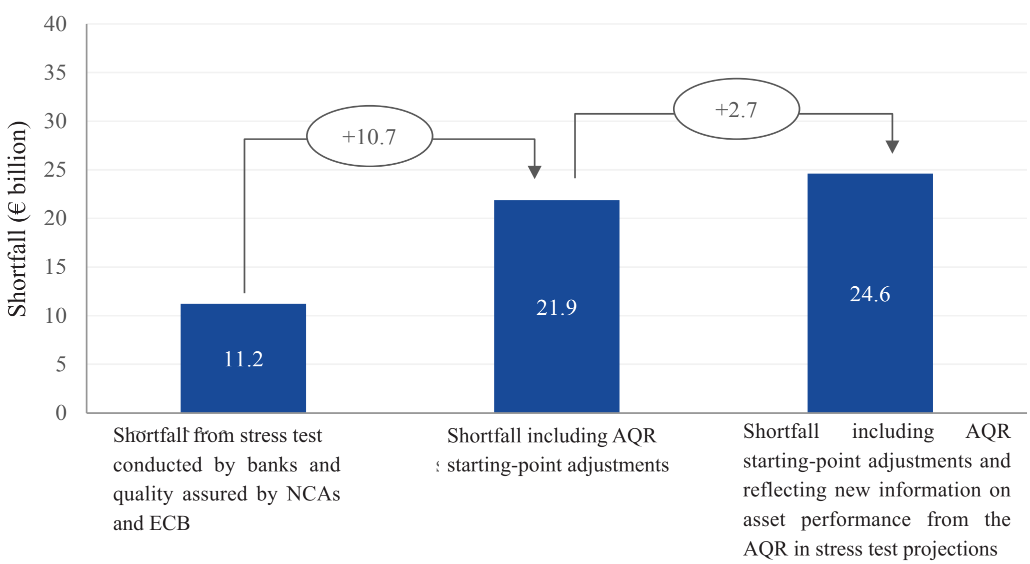
The final number for capital shortfall is a great deal lower than most estimates, which are often based on market prices rather than, as in the case of the Comprehensive Assessment, on book prices. Book prices are the valuations that banks themselves place on their assets. It also seems almost a Goldilocks result – not too hot, not too cold – sufficient weak banks to establish credibility, but not enough weak banks to cause panic.

The Comprehensive Assessment was meant to carry out two roles: to provide an entry point for the Single Supervisory Mechanism and to restore confidence in the European banking system, by being transparent and rigorous. Confidence has, largely, been recovered. However, niggling questions persist, including why a sovereign default was not part of the adverse scenarios and why deflation was not modelled as a stress scenario. In addition, the leverage ratio, the unweighted capital-asset ratio, was not taken into account. While, on average, banks have a leverage ratio above the required 3 per cent, there are 14 banks below it, even before AQR, and, once the AQR is taken into account, 17 fail to pass muster. Given that the leverage ratio will become part of the regulatory rulebook under Basel 3, additional capital will have to be raised.

> The US had an advantage in examining its banks and imposing remedial action

How does the outcome compare with the US process? There is no doubt that the US, with one banking system and consistent regulatory and supervisory standards, had an advantage in examining the health of its banks and imposing remedial action. A political union and the existence of a fiscal backstop, in the shape of the Federal Reserve and the federal government, also made the US exercise much easier and more transparent. Europe suffers from the competing interests of nation states which, despite the fact that there will be a single bank resolution fund from January 2016 (a modest one of €55bn), are, effectively, on the hook for the failure of banks under their jurisdiction.

Capital shortfall by main components



Source: ECB, Aggregate Report on the Comprehensive Assessment. *Free at:*
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The negative feedback loop between the health of banks and the ability of a country to raise sovereign debt means that countries have little incentive to be completely transparent about the health of their financial institutions. The rockier the banks, which hold sovereign debt as "safe" assets, the more expensive, and discounted, will be the sovereign debt needed to fund them.

What is next?

Banks with a net capital shortfall had until mid-November to submit remedial plans, with capital shortfalls expected to be filled within nine months. These capital shortfalls should be primarily filled through private resources. As back-up, national governments would have to undertake public recapitalisation of "their" banks, subject to EU guidelines.

Going forward, many challenges remain for the ECB as bank supervisor. It has to work with different national banking acts, which might not only throw sand in the wheels of its own procedures but also hamper the development of a level playing field in regulation and supervision. Further, there could be arbitrage possibilities when it comes to investing in banks that are directly supervised by the ECB and those that are not. The main concerns, however, lie less with the SSM – the first pillar of the banking union – and more with the other two pillars: resolution and deposit insurance. These both remain unresolved.

The Single Resolution Mechanism will come into effect on January 1, 2016. It was the subject of much haggling, and has been widely criticised, but it goes hand in hand with at least one substantial reform: the bail-in rules that come on top of higher capital requirements, introduced under a separate bank recovery and resolution directive.

However, in its current form, the SRM is still mainly a country-based framework, with supranational support only kicking in at a second stage. The fact that the UK is outside the SRM will critically hamper its effectiveness, given the importance of London as an international financial centre. In addition, the target size of the resolution fund of €55bn would not cover any major bank failure, which leaves the problem of too-big-to-fail unresolved in Europe. Further, and unlike the situation in other larger economies, there is no public backstop funding mechanism in place – something that, as the recent failure of the Portuguese Banco Espírito Santo showed, is much needed. The Portuguese government had to rely on troika (European Commission, ECB and IMF) funding to resolve the bank, in light of its own precarious fiscal position. European sovereigns and their banks are still caught in a deadly embrace.

The third pillar, a common deposit insurance fund, has been quietly dropped, for the same reason that no public backstop has been established for the SRM. Political resistance to loss-sharing across countries was too great.

The lack of consumer demand is a barrier to eurozone recovery

Even in a world with high confidence in the competence, independence and integrity of the supervisory institution and process, the shortcomings of these other two pillars will affect the SSM. How credible can a supervisor be in threatening to close a bank if there is no watertight resolution process in place? Over the past years, we have seen on several occasions that intervention and the resolution of weak and failing banks was delayed because the necessary tools and resources were lacking – the Cypriot banks being the most prominent example.

Will the AQRs and stress tests help the eurozone get out of its economic crisis? Banking union is clearly a forward looking exercise, more to prevent and/or fight the next crisis than to resolve the current one, something that can be seen from the slow phasing in of the SRM and the resolution fund.

However, the successful completion of the Comprehensive Assessment is also a necessary, though far from sufficient, measure to set the stage for a recovery of lending in the eurozone. A well-capitalised banking system will have more confidence in lending to the private sector.

All that said, there are other significant barriers to a eurozone recovery, including the lack of consumer demand and the threat of deflation. A similar exercise to the Comprehensive Assessment undertaken a few years ago and a more rapid (and more complete) introduction of the banking union might have resulted in a different economic situation today.

The national political interests and constraints that postponed the undertaking of the Comprehensive Assessment and the establishment of the SSM for so long also constrain a comprehensive economic policy approach to the current crisis. This would have to be a sensible mix of supply-side structural reforms, fiscal easing and more aggressive monetary easing in the form of quantitative easing – all of which would involve greater political consensus across the EU than is presently forthcoming.

What have we learned?

Beyond being the entry point for the SSM, the Comprehensive Assessment has taught us a lot about supervision in the eurozone. The shortcomings of national supervision within a currency union have been confirmed, as the AQR has revealed glaring discrepancies in asset classification. For example, more than 20 per cent of the reviewed debtors were reclassified as non-performing in Greece, Malta and Estonia. Slovenia even saw a 32 per cent reclassification, with one bank hitting 43 per cent, suggesting a rather high degree of regulatory forbearance.

The fact that many banks pre-empted the Comprehensive Assessment by issuing new equity indicates that this round was taken more seriously than previous ones. These additional equity issues were strongest in Germany, but there were also significant issues in several crisis countries, including Italy and Greece.

Overall, the Comprehensive Assessment is an important milestone to re-establish the Single European Market in banking. However, it is only a first step. This exercise cannot be a one-off but has to be followed with similar, and regularly undertaken, exercises. The banking union is still work in progress. The strongest risk seems to be the feeling that "we have sorted everything out", which will lead to complacency and a rude awakening in the next crisis.

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