How Stressful is the European Bank Stress Test?

Nicolas Véron says that stress-testing Europe's 100 biggest institutions could strengthen the system, spur the economy, and lead to G-20 agreement on bank reforms.

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Steve Weisman: The European Union has embarked on stress tests for their major banks and financial institutions, following what is generally perceived to have been a successful exercise of stress tests of American banks last year. This is Steve Weisman at the Peterson Institute for International Economics, with Nicolas Véron, visiting fellow at the Institute and senior fellow at Bruegel in Brussels, to give us an update on the subject. Thanks for joining us.

Nicolas Véron: Thank you.

Steve Weisman: We're [at] the beginning of these stress tests in Europe. What are we learning about the strength of the major European banks?

Nicolas Véron: What the European authorities have announced—and this is still moving as discussions continue—is that there will be results in the second half of July disclosed to the public. The stress tests are ongoing right now, carried out by national authorities and the European Union but with central coordination provided by the Committee of European Banking Supervisors [CEBS], which brings together the 27 countries of the European Union and with input from the European Central Bank. So the thing that is not new is that these exercises are held in Europe. There was a first stress testing exercise also coordinated by CEBS in September last year. But the big news is that the results will be disclosed to the public. The previous exercise was kept confidential. Even the list of the banks tested was not made public.

A list of 25 big banks was initially published as being [the] core of this stress test. But then you had a lot of backlash—highly justified I think—saying that 25 were too few, that you needed to test the more fragile banks, which tend to be mid-level banks, not the very biggest ones, certainly in Germany and Spain. Now it seems there will be as many as 100 banks affected by this stress testing and for which the results will be disclosed next month. This very comprehensive effort raises a number of questions about coordination and how precise and specific the results will be. But it's a very big change in the European approach to managing the banking crisis. I think it is a very positive development compared to the paralysis of before.

Steve Weisman: Is the lack of faith in the banking system impeding growth in Europe?

Nicolas Véron: I think it is. Of course there are many controversies about credit allocation and whether the apparent credit crunch[es] in Europe and the United States are problems of demand—in that companies don't invest and therefore don't ask for loans—or a problem of supply, because the banking system is in such a bad state that it's impossible for them to extend new credit.

There's a mix of both. But I think there is ample evidence in Europe that there is a supply problem. It's not only about the general volume of credit but very much [like] the case in the Japanese crisis during the 1990s. It's also a problem of allocation of credit, with the typical stylized depiction of the Japanese crisis—of "zombie banks financing zombie companies," and if you're not a zombie company, but you're a healthy company with good investment projects, you don't get the credit you need because all the credit is going to zombie companies kept alive by zombie banks, which themselves are too weakly capitalized to take the risk of seeing these companies go bankrupt.

And it may be the case that we have a bit of that in Europe, certainly in some European countries. Germany comes to mind, and Spain, in the property and real estate sector. So that's where the stress testing is so important, because we hopefully will get an assessment of the capital strength of the banks, which is much more credible than what we get from their financial statements. And this will accelerate the restructuring of the banking system that is badly needed.

Steve Weisman: In other words, some banks will be able to raise capital; some banks will fail or have to consolidate with other banks. What will be the results if the stress test is really rigorous?

Nicolas Véron: If the stress test is rigorous, it will give us an assessment on a comparable basis of the capital strength of all these important banks in the European system, whether they're listed or unlisted.

Steve Weisman: What do you mean unlisted?

Nicolas Véron: Not listed on the stock market: typically state-held banks or savings banks, which have regional stakeholders in the capital base. What we'll see is whether some of these banks need new capital. If, as is likely, some need new capital, but the result is to say nobody needs new capital, it will not be credible. Basically the marketplace is convinced that there are capital shortfalls in the system. Again, there is evidence that lending behavior corresponds to patterns we know are typical of banks that have capital shortfalls. If a bank is found to need new capital, it will have to seek it on the marketplace. Remember that in the United States last year, when the reserves were announced in May, the US authorities concluded that there was actually a very big need for capital for a number of banks. It was in the tens of billions of dollars. They raised it all on the marketplace. So the idea that banks could raise equity on the marketplace is not entirely utopian. Of course, market conditions are not exactly the same now but they weren't that good when the stress tests began in the United States.

Steve Weisman: Would European banks be able to look to different places for capital?

Nicolas Véron: This morning there's news that sovereign wealth funds from the Gulf would invest in a Greek bank. Sovereign wealth funds have been here before and many have lost a lot of money when they invested in big banks in Europe and the United States in 2007 or early 2008. But the point is that in the United States, at the beginning of the stress testing exercise, nobody believed that the marketplace would provide tens of billions of [dollars of] new capital for the least capitalized banks as a result of the exercise. Of course, there is a risk and the possibilities that some banks will not be able to find money on the marketplace and then there will have to be a need for public intervention.

Steve Weisman: By public intervention, you mean public investment of some kind?

Nicolas Véron: Yes, accompanied with some form of restructuring. Clearly, if a bank is found bankrupt or near bankrupt and cannot raise capital from private investors or from a market-based capital raising, then authorities will have to intervene. Of course [there will be] coordination problems, especially if there is a pan-European bank or bank that has activity scattered around different countries. That's what happened with Fortis in 2008.

But I think we can reasonably expect that—just as with Fortis or Dexia or RBS [Royal Bank of Scotland] or Hypo Real Estate or others—European governments will intervene and it will not always be effective. But they will basically find ways to restore the system to a sustainable state, which may need winding down for some institutions or merging them in different pattern. So if this sort of cases emerges, it may imply some volatility. I actually do expect volatility in the run-up to the disclosure of the results, because there will be a lot of market rumors and people jostling for position to convince the marketplace that they're safe and the others are not. But once again, this is much better than the genuine lack of trust that was there before Europeans embarked in this exercise of transparency and disclosure.

Steve Weisman: Let's segue from that topic to the issue of new rules requiring how much capital banks should have, which was a focus of discussion and it seems disagreement in Toronto at the G-20.

Nicolas Véron: Let me just make one final remark on the stress test in Europe, on the conditions for it to be successful. As many people have pointed out, you need to include enough of the overall banking system. This apparently had been sorted out in the last few days by the idea of including as many as 100 banks and not just the biggest 25. But this is not the only condition. You need to have comparability on how the stress testing is done from one country to another. Of course, there is a lot of economic nationalism in Europe, so there's an incentive at least for some national authorities to paint the situation of their banking system as better than it clearly is, to protect it in international competition, which is a concern because of the cross-border integrations in Europe. There's a big issue at stake, which is how consistently will this be done, not only in terms of the stress assumptions but also the methodologies for assessment and how serious inspection will be.

Then there's another thing, which hasn't been that much commented on so far but I think is crucially important. What's the level of disclosure in terms of detail and granularity? It's not enough to say we find a capital shortfall of €2 billion for this or that bank. You need market participants to form their own opinion and to say, "But if I apply somewhat different stress test assumptions, what would this look like?" And this was, I think, the very successful aspect of the US stress test last year. They provided enough detail beyond the bottom line figure of how much capital was needed so that market participants could make their own simulations, their own assumptions. This had an enormous trust-enhancing effect. I really hope the Europeans, as they say they will do, will provide as much detail and specifics as the United States did last year, and perhaps even more.

Now for on your question on the Basel negotiation and the rules on capital liquidity, leverage, and risk management. Yes, if the Europeans manage to put their banking system on a more resilient and sustainable track by this stress testing and all the restructuring that may come as a result of the current stress testing, then we'll have a much sounder basis for the Basel discussions. I think in terms of timetable, that's very important because the Basel discussion is, at this point, supposed to conclude in November. In my expectation it's very possible that the Basel committee will decide to leave some tricky issues for further negotiation beyond November, but at this point that's the timetable we have.

If we have more transparency and more shakeup of the European banking system in the meantime, maybe there will be a better basis for agreement. I wouldn't be too hopeful, though. We now have a Basel committee of 27 participating countries and jurisdictions, which is unusually diverse. It remains to be seen how much a large group can really achieve in terms of agreeing on binding and specific and demanding rules for the banks.

My expectation is that we'll have perhaps more differentiated rules typically between countries of different levels of development and that the sort of uniform philosophies that underpin the very notion of the Basel discussion may have to be adapted to the diversity of the world we're dealing with. Let's not forget that at this point, the largest banks in the world are not from the West but from China and emerging markets, so we have to deal with this new situation, which is entirely unprecedented.

Steve Weisman: Will the markets accept a differentiation?

Nicolas Véron: I think the differentiation exists. I mean Basel II is not uniformly implemented in the world even among the countries that say they implement Basel II. Actually there are enormous differences of practice. So we're not starting from a harmonized world when it comes to banking regulations. The aim is to harmonize it a bit more. But frankly, and this is familiar discussion for Europeans, you have to take some form of what Europeans call the subsidiarity principle. The idea is that you can do things centrally on a supranational basis—but only for these things that really cannot be done the right way on a nation-by-nation basis. So perhaps some aspects of the current Basel agenda could be decentralized. Maybe the Basel committee will need to be more discriminating in what it takes for itself at the global level, compared to what can be left to national discretion.

Steve Weisman: Nicolas, thank you very much.

Nicolas Véron: Thank you, Steve.