



## Mixed Results from the European Bank “Stress Tests”

*Nicolas Véron says stress tests provide useful information about European banks—and pose a challenge to governments over their need to recapitalize.*

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Steve Weisman: Today, July 15, the world has a new and better picture of the health of the European financial system, because of the announced results of a new round of stress tests. Nicolas Véron, visiting fellow at the Peterson Institute for International Economics is here to answer questions about those results. This is Steve Weisman. Nicolas, what’s the headline from the stress tests?

Nicolas Véron: There are really two ways to look at it, because there are a lot of additional disclosures. The headline is about which banks pass the stress test, which banks didn’t pass. Here, the number of banks that didn’t pass is low. A number of financial institutions considered by near-consensus of the marketplace to be under capitalized did pass. So this just mirrors the fact that the stress test scenario and the conditions that were factored into the analysis look very mild now compared to the market turmoil that we have, for example, in Italy...

Steve Weisman: How many failed the stress test, and how many are under capitalized as a result of this survey?

Nicolas Véron: We have eight financial institutions, which didn’t pass the test, which are found under the five percent core equity threshold that was defined as a condition. That’s eight out of 90 banks tested, many of them in Spain, but this is probably not the true picture of the fragility of the European banking system.

One element that is important is the deterioration of the market conditions in the past weeks and even days. For example, now Italy obviously is a big concern. There was no indication whatsoever in the stress scenarios that you would have a problem with Italy.

Steve Weisman: Was there a default of any kind factored into the stress test?

Nicolas Véron: No, there was no default in the stress test. But the deterioration of the financial conditions for Greece was put into the methodology of the stress test assessment and therefore the holdings of Greeks sovereign debt that didn’t have to be marked to market. But they had to be subject to a risk assessment and to an expected loss assessment in the stress test. But there is nothing of this nature obviously for Italy and for other eurozone countries.

Steve Weisman: How many were deemed undercapitalized, but short of failing?

Nicolas Véron: A number of them, I think 15, were found between five and six percent core equity, so that means less than one percent more than the threshold.

But, you know, the European member states have defined five percent as the threshold under which it would impose recapitalization, so basically the question now, as it was last year, is: will government force those who have passed the test but are still close to the limit to raise new equity? The evidence so far is not very encouraging...

Steve Weisman: In your view they should?

Nicolas Véron: Yes, they should. And some of them will. But it will not be uniform and it will probably be more protracted than should be the case, because many of these banks have had big falls in their equity values in the past few months. Therefore raising new capital involves a lot of dilution for the shareholders.

Steve Weisman: Do you think the markets, in examining the related material that comes out of the stress tests, will force them to recapitalize?

Nicolas Véron: At this point market pressure on individual banks is not as powerful as what government pressure can be. So the ball is very much in the court of the governments. But you're right that the market has all this information and will be able to defer and shade better than it would before the disclosure. The other aspect of the stress test beyond the headline announcement of which banks fail and which banks pass, there is all this treasure trove of information.

It's a bit like a financial equivalent to Wikileaks. Right? It will take some time for analysts to really go through it and understand exactly what's in there. Also perhaps, unlike Wikileaks, there will be differences from one bank to another and especially from one country to another in the quality of the information, how reliable are the numbers, what exactly is behind them in terms of assumptions and audits and verifications.

So it's not information that's necessarily easy to use, but even so it goes way beyond what we had before. It's much, much more detailed than last year's stress test. One count is that there were 100 data points last year. There are 3,000 this year, so basically we have a lot of material for analysts to work with.

Steve Weisman: This is the second or the third stress test since the crisis began?

Nicolas Véron: It's the second one for which the bank-by-bank results are disclosed to the public. It's the third one overall. There was a first one in September, 2009, for which only aggregate and therefore largely meaningless results were disclosed publicly.

Steve Weisman: You've been calling for rigorous stress tests. This was better, but it's not there yet. Are they going to have another chance?

Nicolas Véron: In any case it comes very late. At the beginning we had a banking crisis and we have still the banking crisis largely unresolved, but a sovereign debt crisis.

Now on top of the banking crisis and the sovereign debt crisis, we have an institution crisis for the EU more and more visibly because of the inability of the European Union and its institutions to make the necessary decisions in due time is more and more obviously part of the problem right now.

The banking situation is important and there many things to do in that area. But it's only one part of a much bigger set of problems. In the banking space, the biggest problem is no longer the identification of which banks are weak. It's forcing weak banks to recapitalize or restructure.

And this is something at this point only some governments can really do, because the market discipline is weakened by what is otherwise necessary, which is extraordinary liquidity support, which is provided by the ECB and by some national central banks on top of the ECB to the different banks.

Basically the markets cannot just force banks into restructuring by cutting funding, because there is this public funding in enormous amounts to the most problematic banks.

So it's a matter of decisions by the governments and by the EU authorities. That's also what explains confusion in the marketplace right now, because investors are well-equipped to deal with economic risks and to model economy risks. They're very poorly equipped to deal with political risks and with the situation like the current one when political factors are basically what is driving the marketplace. This is very confusing for private sector investors.

Steve Weisman: Political factors are driving what is called "private sector involvement" in a Greek rescue, which is a euphemism for restructuring the debts held by the banks. Did the stress test take into account the latest talk in the last few weeks of such private sector involvement?

Nicolas Véron: To the extent that Greek bonds were marked down by the methodology imposed last month to the banks by the European Banking Authority, the answer has to be yes. I mean, there was some taking into account the possibility of losses on Greek bonds.

Now is it commensurate with what is likely now? It's very difficult to answer this question because...

Steve Weisman: We don't know what is going to happen.

Nicolas Véron: The whole concept of private sector involvement had been very fuzzy from the beginning. We've been through all sorts of extremes even in the last few days of no PSI at all, or a very substantial PSI that contributes a very substantial amount of debt reduction and therefore a possibility of the way forward in terms of making the Greek sovereign debt situation sustainable.

Steve Weisman: How is this...?

Nicolas Véron: It's so confusing that it's not surprising that the stress test doesn't integrate it all.

Steve Weisman: How are these results going to play into the negotiations over the next week about what to do about Greece?

Nicolas Véron: I think they're not a central factor for the next steps of the negotiations. That said, it is to be hoped that the information disclosed will be found of a sufficient quality to allow investors to form a better picture of the European banking system.

Therefore to provide better funding conditions to the banks that are objectively strongest in the system, because one should never forget that this whole process of triage is not just about identifying which banks are weak, but also which banks are strong and therefore can be trusted given normal funding conditions.

That's one thing. The other thing is that one can hope, but not be sure that the publication of the stress test results will accelerate actions to restructure the banking system in countries in which [the system] does need restructuring. And the first name that comes to mind here is Spain, where there has been a perception of a loss of momentum in the restructuring of the savings banks and of the problem banks that are hit by lots of real estate losses.

And one can hope that the stress test will put this drive power to restructuring back on a better track. But again, I think that this is not entirely a side show but the main issue now. The main issue now is how to deal with countries and not just individual banks.

Steve Weisman: Nicolas, thanks.

Nicolas Véron: Thanks to you, Steve.

