Were European Bank Stress Tests a Whitewash?

Morris Goldstein lists many shortcomings of the comprehensive assessment of banks in Europe, which he says would have found major banks lacking capital if more rigorous standards had been applied.

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Steve Weisman: If Europe is to ever recover from its financial crisis and economic downturn people are going to have to have confidence in its banking system. Europe has just completed an evaluation of that system.

This is Steve Weisman at the Peterson Institute for International Economics with Morris Goldstein, to tell us about that evaluation, in effect to evaluate the evaluation.

First Morris, thanks for being here and tell us what the evaluation consisted of.

Morris Goldstein: Well, thank you Steve. What the evaluation consists of is an exercise on a 123 European banks where you try to determine whether these banks will have adequate bank capital in an environment that's very adverse and stressful. So you do these scenarios of adverse events and you try and see whether banks have enough capital to remain solvent.

Steve Weisman: So that's why they call them stress test.

Morris Goldstein: They have to be stressful, that's right.

Steve Weisman: What was the result, how many banks at least according to the evaluation passed this stress test?

Morris Goldstein: Well, most of the banks passed. The report actually has four main findings. They are, the capital shortfall for the 123 banks together is about €25 billion. Second, only 24 EU banks failed the test. That is, they're undercapitalized. Even less, once you take a count of the capital that they raise at the beginning of the year, 14. Third, the undercapitalized banks are all in Greece, Cyprus, and Italy. And finally, the largest banks in France and Germany have ample capital.

Steve Weisman: So, this was taken as pretty good news by—in a lot of media accounts. Was it really?

Morris Goldstein: Well, I don't believe it for a minute. In other words, I find the results not, I repeat, not credible and there's quite a few reasons for that.

Steve Weisman: Okay, let's go over that one by one. First?

Morris Goldstein: Well, the main defect and the one I'm going to spend the most attention on is that the test does not include a so-called leverage ratio. I read the entire 51-page report and the term leverage ratio is nowhere to be seen.

Steve Weisman: Well, before we proceed, what does the term mean?

Morris Goldstein: Well, I'm going to explain. There are two kinds of bank capital ratios. The first kind we call risk-based capital ratios and what they do is you take each kind of bank asset and you weight it, you give it a weight between a hundred and sometimes more between 0% and 100%, sometimes it could be even more than 100%.

So for example, if your bank makes a car loan that could have a risk weight of 100%. If it makes a home mortgage that might only have a risk weight of 25%. And you take all these different kinds of loans and you weight them up and you get a final figure called risk-weighted assets and that's what you put in the denominator of the capital ratio. So that's one kind of capital ratio.

The second kind is called the leverage ratio, which I just mentioned. The difference there is in the denominator, you don't use any weights. You put all the bank's assets and you don't weight them at all. So, that's the difference. And you may say, "Well, why should I care about this thing? It's very arcane. What?" Well, it turns out to matter a lot because in the last decade there's been a lot of research and what that research shows is that leverage ratios do a good job of distinguishing sick from healthy banks, whereas the risk-based capital ratios do a very bad job. And the ECB in its 2014 test used only the risk-based measures.

So consider the following facts when you're trying to evaluate these results. If you look at the 10 largest US banking firms before the 2007 to 2009 crisis, they all reported high risk-weighted capital ratios. All the regulators said they're very well capitalized. In contrast the leverage ratios were telling you that these banks had very thin capital cushions, that they were very fragile. Well, a lot of those banks wound up needing official support. So the leverage ratios were telling you the right thing, the risk-based capital ratios were telling you the wrong thing.

Similarly, if you look at median capital levels for the top 20 EU banks, you find that their leverage ratios decline from around 6% in the mid-1990s to just about 3% before the crisis. So again, thin capital cushions. The risk-based ratios were telling you that they're very well capitalized. Again, the leverage ratios gave you the right indication of fragility; the risk-based ratios gave you the wrong one.

If you look at the bank that had the highest risk-based capital ratio in the 2011 test, which was the last test the ECB did before this one, who was at the top of the list? A bank called Irish Life and Permanent. It had a huge risk-based capital ratio. So it should have been very, very safe. In 2012, that bank had to go into government restructuring.

Dexia, the large Franco-Belgian bank, passed the 2011 test using risk-based ratios in flying colors. A few months after that Dexia had to be rescued at great taxpayer expense. And there's been a study, an important study in 2013 by two European economists. And they found that using leverage ratios in the 2011 stress test would have produced dramatically different results. If you'd used the 3% leverage ratio as the target that banks had to hit in that test 26 banks would have failed instead of three and among the failures would have been the largest German and French banks: Deutsche Bank, Commerzbank, BNP Paribas, SocGen; a 4.5% leverage ratio would have caught all the EU banks that failed over the next two years. In contrast a risk-based measure, no matter how high you set it, you wouldn't identify the banks that subsequently failed.

When sensible leverage ratios are used for the capital hurdle rate in this test the aggregate capital shortfall for EU banks winds up in the hundreds of billions of euros, not the 25

billion or the 14 billion that the EU, ECB tells you is the total shortfall. The US Federal Reserve runs stress tests that include a leverage ratio. They've done that since 2012. The Bank of England later this year is coming out with its own stress tests; they're going to have a leverage ratio. Canadian banks use a leverage ratio. According to IMF figures the large EU banks have lower leverage ratios than large US banks in the same accounting framework.

In view of all the above I think the press and bank analysts ought to put three tough questions to ECB President Draghi and to Ms. Nouy, who is the manager of this stress test. Question number one, why didn't you include a leverage ratio in the 2014 stress test? Question two, will you include a leverage ratio in the next EU-wide bank stress test? If not, why not? Third, suppose the ECB had included the leverage ratio in the 2014 test. Suppose we let them pick the capital measure they like the best, a common equity tier 1 and then we said, "Well, but now you have to use total assets in the denominator. Let's put a hurdle rate of say 5% from the baseline scenario and 4% for the adverse scenario. If you did that how many banks are going to fail? Will Deutsche Bank pass? Will Commerzbankpass? Will BNP Paribas pass? Will SocGen pass?" That's the question we need the answer to and that's why I think these tests are not credible.

Steve Weisman: So let me just ask you to conclude by saying what the market reaction has been from these stress tests. The immediate reaction has been moderately positive. What about the markets?

Morris Goldstein: Well, yesterday bank stocks went down, so I think that's appropriate. I think the test is disappointing. What we need is truth in advertising and this really didn't meet that. But you also have to recognize this is a pretty arcane issue. I'm talking about these different kinds of capital ratios; a lot of people say, "Well, they did this asset quality review and it took a long time." But in the end you really have to ask yourself, "Are these results credible?" And the test they use is not a robust test and if they'd used the leverage ratio I think they would have got entirely different results.

Steve Weisman: Well, on that note, thank you very much Morris.