CEPS COMMENTARY
Thinking ahead for Europe

The second EU bank stress test
Further work in progress

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22 July 2011

The second stress test, the first executed by the new European Banking Authority (EBA), provides a broad picture of the state of the European banking industry. Applying a stress scenario of a 2% reduction in real GDP growth in the EU and the euro area in both 2011 and 2012, the test finds that eight banks, out of a total of 90, would fall below a capital threshold of 5% of core Tier 1 capital, or a total shortfall of €2.5 billion. Another 16 banks fall below the 6% Tier 1 target set by Basel III, or an additional shortfall of €8.2 billion. One in four of the banks in the sample failed to meet the stress test benchmark, with important cross-country differences (see table below). The EBA ordered national supervisors to take the necessary measures to adjust the 5% shortfall within 3 months and the 6% shortfall within 9 months.

The results of the latest stress tests were published 15 July 2011, in a context of great uncertainty about the debt situation of some member states, and the future of the eurozone. The situation of some eurozone member states had deteriorated markedly in the year since the results of the first EU test was published, with substantial sovereign downgrades by rating agents and growing financing problems for the banks concerned in these countries. Foreign banks' sovereign exposures to these countries had also depreciated considerably.

For a brief period, the results of the 2010 stress tests brought relief to EU financial markets, until it emerged a few weeks later that the capital needs of some banks were underestimated and that other 'non-systemic' but borderline banks had not been included in the test. The 2010 test concluded that an additional €3.5 billion in capital was needed for about seven banks. But by mid-August 2010, the moribund Anglo-Irish Bank was in need of another €10 billion, and by September, it appeared that the capital needs of Spanish savings banks were much bigger than projected. It was expected that the second stress test would thus make marked improvements.

In contrast to the remit of its predecessor, the Committee of European Banking Supervisors (CEBS), one of the core tasks of the EBA is to conduct stress tests. The Authority is mandated to monitor and measure systemic risk, and must maintain a permanent capacity to respond to situations of rising risk (Arts 22-24, EBA Regulation). The EBA, in cooperation with national authorities, needs to collect all necessary information to execute its task and create a centrally accessible database of registered financial institutions (Arts 8 and 35). To perform these tasks, it can issue guidelines and recommendations to national supervisory authorities,

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who are legally obliged to comply (Art. 16). This expanded remit was already clear from publication of the results, which were presented by the Chairman of the EBA, Andrea Enria, with the endorsement of Commissioners Michel Barnier and Olli Rehn, as the EBA has now become an agency of the European Commission. The results are accompanied by a two-page recommendation to the national authorities, requesting them to submit a detailed overview of measures to be taken by the banks in question by 31 October 2011.

As an indication of the difficulties facing the EBA in following through in this task, however, it suffices to look at the reactions of the national authorities and banks to the release of the stress test results. In Spain, where five banks were singled out in need of recapitalisation, the central bank announced that "no Spanish bank needs to increase its capital as a result of this exercise (…) thanks to the loss-absorbing mechanisms specific to the Spanish financial system". Helaba, the German Landesbank, insisted that its test results not be made public, as it disagreed with the EBA on the evaluation of its capital base. The Bank of England, from its side, made no reference at all to the results on its website.

The EBA states that the results reflect an unprecedented level of transparency with respect to EU banks' exposure and capital composition, as the number of data points has increased exponentially. However, the stress test still covers only 90 banks – like last year – or about 65% of the EU financial system, and the quality of the disclosed data leaves room for improvement. Data reporting needs to be further harmonised and streamlined across countries. The Lloyds Banking Group in the UK, for example, disclosed its credit exposures only for the domestic market, declining to disclose exposures in Ireland, as they would fall below the disclosure threshold. Likewise UniCredit did not reveal country-by-country data for branches of its Austrian subsidiary Bank Austria. Furthermore, the EBA mentions in the notes that there might be instances where banks have included exposures to public sector entities as institutions, whereas others may have included them as sovereign debt. The dataset is very much focused on country exposures, while funding sources that are important for examining the liquidity positions are neglected.

The European Commission from its side stated: "today's results highlight that the great majority of European banks are now much stronger and better able to resist shocks", thanks to more rigorous tests and a stricter definition of capital. However, the test continues to rely on the old definition of Tier 1 according to Basel II – but using the new thresholds of minimum 6% Tier 1 of Basel III – and no risk weights for EU sovereign debt. The EBA only states that increased provisions have been made for sovereign exposures in the banking book, but the provisions still seem conservative. In the past months, the CDS (credit default swaps) rates of Greece, Ireland and Portugal have already reached levels above the applied haircuts. The risk weighting also has a favourable bias towards real estate, where a risk weighting of 35% is applicable for residential mortgages under the EU's Capital Requirements Directive (CRD). A finally weakness of the latest stress test is that it does not provide information on the net derivatives position of banks.

In short, the EU bank stress test has clearly been improved compared to the first round, thanks in part to the new institutional set-up. Much works remains to be done, however, on the substantive side to further calibrate the results and extend it to a broader sample of the EU banking sector.

Total capital shortfall in adverse scenario for banks in EBA sample (€ bn)

	Core Tier 1					
	4%	*5%*	*6%*	*7%*	*8%*	*9%*
AT	0.0	0.2	0.5	0.8	1.4	3.9
BE	0.0	0.0	0.0	0.0	0.0	0.0
CY	0.0	0.0	0.2	0.7	1.3	1.8
DE	0.0	0.0	0.8	7.5	21.6	36.1
DK	0.0	0.0	0.0	0.0	0.0	0.0
ES	0.6	1.6	5.9	13.9	23.2	36.9
FI	0.0	0.0	0.0	0.0	0.0	0.0
FR	0.0	0.0	0.0	3.2	13.9	33.5
GB	0.0	0.0	0.0	4.8	17.7	42.0
GR	0.6	0.8	1.7	2.8	4.4	6.7
HU	0.0	0.0	0.0	0.0	0.0	0.0
IE	0.0	0.0	0.0	0.0	0.6	1.2
IT	0.0	0.0	0.3	3.8	11.8	20.6
LU	0.0	0.0	0.0	0.0	0.0	0.0
MT	0.0	0.0	0.0	0.0	0.0	0.0
NL	0.0	0.0	0.0	0.0	0.2	1.8
NO	0.0	0.0	0.0	0.0	0.0	0.0
PL	0.0	0.0	0.0	0.0	0.0	0.0
PT	0.0	0.0	1.1	3.3	5.8	8.3
SE	0.0	0.0	0.0	0.0	0.0	0.4
SI	0.0	0.0	0.1	0.3	0.4	0.6
Total	1.2	2.5	10.7	41.1	102.1	193.8

Data source: EBA, EU-wide stress test 2011.