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Placing EU Banks under Undue Stress

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The latest round of European Banking Authority (EBA) stress tests has rather short-sightedly focused on one measure of capital: the Tier 1 capital ratio of Basel III. While the first two stress tests underestimated the capital needs in the European banking system, the third test risks overestimating the picture of the capital needed in some cases. By solely employing a 9% Tier 1 ratio, with a correction for market valuation of sovereign exposures, the overall end result is that banks with higher risk-weighted assets in embattled sovereigns need to put up more capital than those with lower risk-weighted assets in the core eurozone countries. This unduly penalises banks that provide credit to the real economy in those member states where it is most needed, which is contrary to the European Council's stated intentions following its meeting on October 26th.

The third stress test was administered to the same 70 banks that participated in the July 2011 EBA exercise, as well as a subsection of smaller non-cross-border banks. The EBA calculated that about €106 billion is needed to recapitalise EU banks, compared to earlier estimates of €2.5 billion following the first stress test and €3.5 billion in the second. No less than 80% of the capital shortfall must be met by banks established in Greece, Italy, Spain, Portugal and Cyprus. The list is topped by two well-known banks, Banco Santander and Unicredit, whose exposure to Greek debt is insignificant compared to that of their other European peers, but whose levels of risk-weighted assets are much higher.

The October 26th European Council statement accompanying its decisions rightly stressed the need to restore confidence in the banking sector. The heads of government argued that this should "avoid a credit crunch and safeguard the flow of credit to the real economy". But whether their decision enhances "the quality and quantity of capital (…) in a reliable and harmonised way", as called for, is another question. One cannot avoid the impression that the Franco-German axis has once again been at work behind the scenes.

The Council gave the selected banks a deadline of June 2012 to comply with the targets of the EBA test, after which time the EFSF recapitalisation facility can be used for banks based in the eurozone. This compares to 2019 as the original deadline for meeting the new Basel III ratios. Banks could use other sources of capital, such as rights issues, but EFSF funding will be subject to the EU's state aid rules, and hence it will be conditional on adequate restructuring being undertaken and remunerated at market rates.

The prime reason for the somewhat distorted outcome is the use of the Tier 1 ratio of Basel III, which gives a misleading indication of the risk-absorbing capacity of a bank's capital, as it uses risk weights for the assets. That is, banks need to set aside capital on the basis of the riskiness of their assets. The averages of risk-weighted assets to total assets vary from 17% to

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58% among large EU banks. In addition, the correction for sovereign exposures was based on September data, which would already look quite different if recalculated based on the latest available data.

EU legislation on the subject, namely the Capital Requirements Directive (CRD) I and the draft CRD IV, requires no risk weight for investment-graded EU sovereigns, and hence makes no provision for banks to set aside capital to absorb eventual losses. The possibility that this oversight can lead to problems was amply illustrated in the recent failure of Dexia. The Belgian-French bank had a core tier-1 ratio well above 9%, thanks to substantial sovereign holdings, but a tangible equity ratio of less than 2%.[1]

The EU should therefore use the Basel III ratio of tangible equity (or leverage ratio) as a criterion in its analysis of the capital needs of the EU banking sector, and not the core Tier-1 ratio. The calculations behind the core Tier-1 ratio are non-transparent, unintelligible and prone to misuse.

[1] See Willem Pieter De Groen (2011), "A closer look at Dexia: The case of the misleading capital ratios", CEPS Commentary, CEPS, Brussels, 19 October (www.ceps.eu/book/closer-look-dexia-case-misleading-capital-ratios).