

## Europe's Stressed Banks

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Europe's stress test for banks, its first-large-scale experiment with financial transparency, is now underway. Until recently it was taboo to acknowledge that there could be problems in the European banking sector. The fact that the EU's political elite, including its various national supervisors, are now actively promoting the publication of the stress test results for all systemically relevant banks is hugely important because it means that the problems can no longer be denied.

But why is there a need for stress tests in Europe so late in the game, almost two years into the financial crisis? The simple answer is because until now, the banking problems in Europe have been swept under a carpet made of blanket state guarantees.

Europe's financial markets remain under stress because Europe's banks are undercapitalized and overly connected. The degree of interdependency among European banks, especially those in the euro area, can be gleaned from the fact that interbank liabilities come to about €6 trillion, or more than 50% of eurozone GDP). This exposure implies that any failure of a single large institution would affect the entire system.

But on top of the interconnectedness comes a disturbingly high degree of leverage. European Central Bank statistics show that euro-area banks have on average about €20 of liabilities (including interbank debt) for every euro of capital and reserves they hold. A similar picture emerges if one looks at the core capital ratios used by regulators and supervisors. This ratio stands now at about 4% for Europe's larger banks, which means that these banks hold on average only about €25 of risk-adjusted assets for each euro of core capital. This high degree of leverage implies that for every capital loss of one euro there will be about €20-€25 of doubtful debt.

Given that the entire Greek public debt amounts to less than 3% of eurozone GDP and only about 1% of euro-area banks' balance sheets, Greek (and other doubtful debt) make up only a small share of the overall balance sheet of European banks. But the problem is that the holding of Greek debt (and claims also on the other countries in financial difficulties: Ireland, Portugal and Spain) tends to be quite concentrated. It is of no use to know that the banking sector on average has (barely) enough capital to survive a restructuring of Greek public debt or further large-scale losses in lending to the Spanish real-estate sector but not whether this is also true for individual banks. Banks are expected to lend each other vast amounts of money at close to riskless rates. They will do so only if they can be sure that their

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counterpart will still be there tomorrow. So it is crucial to know which banks would be affected by the potential losses in Greece and Spain.

For the tests to have any effect, they must incorporate the scenarios on which investors are focused. At present, investors aren't worried about whether growth will be one or two tenths of a percentage lower than anticipated. The recent forecasts of the IMF have confirmed what everybody knew already: The recovery remains slow in Europe in general and there is no recovery in sight at all for fiscally stressed countries like Spain.

The key concern is clearly public debt. Here it seems that a step in the right direction will be taken since it has been reported that the tests will assume a 17% haircut on Greek public debt.

But it would be wrong to focus only on sovereign debt. Large potential losses are also lurking behind the lending to the Spanish real-estate sector. This does not concern only Spanish banks. The total exposure of euro-area banks to Spain is close to €1 trillion, only a fraction of which is government debt. Hence, for Spain the key variable is the rate of losses that could materialise in the private sector. It remains to be seen whether supervisors all over Europe will take a common and tough line on this issue.

While a properly performed stress test can help stabilise financial markets by removing uncertainty about a bank's balance sheets, it might simultaneously raise new questions.

First, EU banking regulation assumes that eurozone government bonds are riskless if held to maturity. It is thus not surprising that banks have massively shifted their bond holdings from their trading to their banking book, where euro-area sovereign debt can be booked at face value (irrespective of the market price) and has a zero risk rating. The official core-capital ratio mentioned above thus includes institutions that are not required to hold any capital to underpin large holdings of Greek long-term debt, which they book at face value even though it now trades at 50-60% of par. How long can official regulation remain based on the assumption that euro-area government debt is riskless when supervisors assume a 17% loss in a stress test?

Second, the current stress-test exercise also shows the kind of conflicts of interest that central banks can encounter when they participate in macro-financial supervision. The European Central Bank has recently bought about €50 billion of 'distressed' Greek, Irish and Portuguese government bonds. Its total exposure to banks in the four most troubled eurozone countries is more than €200 billion. This raises the question whether one should also do a stress test on the ECB.

Like all banks, the ECB has every incentive to insist that there cannot be any risk in these positions and that it will not take a loss on them. It thus faces an acute conflict of interest: For the sake of macroeconomic stability, it is important to subject the balance sheets of banks to stress tests and to publish the results. The exercise will be the more effective the stronger the test, i.e. the higher the assumed loss is under the stress hypothesis. It might soon be time to apply the same standard to the ECB as well.