THE EUROPEAN DE-STRESS TEST

Fearing a repeat of turbulence in financial markets, indeed a collapse in the financial system, since 2008 policymakers have sought to eliminate doubts about the solvency of individual banks through capital injections or other guarantees. This has led governments to bail-out banks, and regulators to insist on ever greater stocks of capital and liquidity to shock-proof the financial system.

Europe’s weak growth prospects are now testing the limits to this approach. There is a growing recognition that unless banks extend sufficient credit, the European economy could stagnate for a prolonged period. In this environment, Europe’s banks will remain fragile as impairments increase and capital generation through profit growth is limited.

Low growth is also likely to mean a sustained period of low interest rates in most of the EU. This is bad news for banks as it compresses interest margins, their principal source of revenue. And if a bank tries to pass on its own interest costs to its borrowers, this can affect the credit quality of its loan book, leading to higher capital requirements and impairment charges.

Policymakers now have an opportunity to address these issues, and in particular to decide what to do about the suggested procyclical effects of the new capital and liquidity rules. The announcement that Basel rules will be eased is a first sign that the approach might be changing.

There is a danger that this adjustment is too slow, and that policymakers remain too focused on stability in the here and now. Given the uncertainties about Europe’s economy, there are good reasons to preserve the Basel III status quo. It would take a courageous bank supervisor to ease capital and liquidity standards in support of growth and future bank profitability. Yet this needs to happen.

Another issue to be addressed concerns the large stock of impaired loans sitting on the balance sheets of Europe’s banks. In Spain, Ireland and Greece, a decision was taken to capitalise banks for the losses which could arise if enough of these loans default. This has been its own costly orthodoxy. The ECB will need decide whether to adopt the same aggressive stance, or to give banks the time to work through their loan books. This second option works in a growth scenario, but it is unclear this will happen if growth fails to lift borrowers’ credit quality.

These challenges are likely to be debated hotly as the next EU-wide stress test is constructed.

The Good Bank program
A unique project organised by the Economist Intelligence Unit (EIU) to examine how banking can better serve the needs of society. It will bring together experts to discuss and share ideas on what makes for a Good Bank and to participate in a conversation about the future of financial services. This will involve curated expert essays, independent EIU research and online engagement culminating in a live panel discussion on June 4th. The three key pillars which will form the backbone to the discussion are: the effective bank, the trustworthy bank and the innovative bank.

Previously, these tests focused on individual bank solvency at a point in time. This crude, pass-fail approach, which Europe adopted from US and UK examples, was arguably necessary in the middle of the crisis, when survival was measured in days. Now that the immediate pressures on banks appear to have abated, the question being asked is whether a simple repeat of these testing measures will actually do more harm than good.

In fact, it is far from clear what a test of bank solvency will reveal that is not already known, or at least suspected.

The question facing Europe is not which of its banks are weak: it is how this situation can be changed and how it will be paid for.

As the Eurozone’s new bank supervisor, the ECB has an opportunity to force the pace on bank resolution. In doing so, it should be guided by a concern for growth. As the US has demonstrated, economic expansion is the best way out of banking system weaknesses.

So what combination of measures can the ECB pursue?

If one measure of success is renewed credit creation, then it must deal with banks that are not viable, or which contain non-viable business units. This will remove those banks from the market which distort the flow of credit from savers to borrowers.

For the same reason, it needs to press banks to deal with non-performing loans, and in particular to restructure the credit facilities of viable borrowers. It is not in Europe’s economic interest that good businesses should be starved of credit because a bank is slow to restructure its balance sheet.

Another reason to deal decisively with non-performing loans is to remove the doubts which have arisen about the adequacy of capital in Europe’s banking system. The ECB’s extension in 2013 of three year money to banks removed immediate liquidity pressures. It is far from clear, though, that capital markets will re-open fully until there is confidence in the integrity of balance sheets.

Creative use of the European Stability Mechanism could allow supervisors to tackle this impaired loan stock. The sweeping of such assets into a separate vehicle, with the ESM injecting capital to cover losses on transfer, would clean-up balance sheets quickly. A softer approach would be for the ESM to insure or guarantee the losses on impaired assets. This could reduce the capital banks have to hold, and thus encourage lending.

The choices the ECB makes about the next stress test will reveal its ambition, or its lack. It does not hold all of the cards: ultimately Europe’s politicians need to decide how to pay for the losses embedded in the current’s banking system. What the ECB can do is explain that these losses will be that much greater the longer Europe’s economy stagnates. It can also identify the actions needed to deal definitively with banking system weaknesses. If included in a test, this second might de-stress this system.

In 2011, Ireland delivered a combination of measures which has allowed the Sovereign and its banks to re-enter the markets. Crucially, the stress test was accompanied by actions to restructure banks and deal with troubled loans. If the ECB can repeat the same feat for the Eurozone, this would more than justify the twin decisions to centralise bank supervision and put the ECB in charge.