



European Bank Stress Tests Succeed by Falling Short

Anders Åslund says the long-awaited stress test results, released July 23, were too easy on the banks but provide useful data that could strengthen the system.

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Steve Weisman: How stable and healthy is the European banking system? Today, July 23, the European stress test results have been released. This is Steve Weisman at the Peterson Institute with Anders Åslund, senior fellow here at the Institute, to assess the stress test which came out today. Thanks, Anders.

Anders Åslund: My pleasure.

Steve Weisman: Let's start out by explaining the scope of these so-called stress tests.

Anders Åslund: Well, the natural comparison is, of course, with the American bank stress test, which was published on the seventh of May, 2009, 14 months ago. And that covered 19 banks while the European bank stress test covered 91 banks. The difference here is that the US banking system is so much more concentrated since it's only one country. So, both covered 65 percent of the banking assets.

Steve Weisman: And the purpose of the European stress test was to disclose the health and capital and assets of the banks. Does it succeed in doing that?

Anders Åslund: Yes and no. It did succeed in the sense that we know much more about what the European banks have and how sensitive they are to various kinds of shocks. And we even know for several countries: how much of these particular dangerous assets they have. At least Spain and Germany have publicized how much of the Greek bonds the banks hold. What they did not explain as well as the American stress test was how much capital would be really needed [for the banks to be considered sound]. They were comparatively softer, and I can show this with one number.

The American stress test asked for \$75 billion more of capital in the 19 banks while the European bank stress test asked for \$5 billion only to be put into 7 out of these 91 banks. And an expectation would have been that it would have been a substantially larger volume of bank capital needed in Europe.

Steve Weisman: You've said, I think, that the expectation was that the need for increased capital was many times more than \$7 billion. What would be the need if these stress tests had been as rigorous as you had wanted them to be?

Anders Åslund: Something over \$100 billion. And we have even seen our banks that have gone through the stress test are immediately saying that they are going to raise more capital. So, they recognize that the stress test was not sufficiently serious. But I think that the most important aspect is that we know so much more about the banks. And we would probably

get much more information since this is being left out by the national bank inspections or central banks. And each of them does not want to be outdone by the others. So probably we will get a competition in transparency, which would be very useful.

Steve Weisman: That would be healthy, right?

Anders Åslund: Absolutely.

Steve Weisman: Even though there [was] some great inflation here—in other words, everybody got an A—was there enough information for the markets to make a harsher judgment?

Anders Åslund: Yes. I think that now people will know which banks are in danger and which are not. That is something that we can say very definitely from this stress test. Some criticism that has been raised here in the United States, which is not justified, is that the US stress test contained much harsher criteria as an adverse scenario than the European stress test. For example, that GDP would fall by 3.3 percent. But that was 2009. Nobody thinks that GDP could possibly fall more than at most a percent in Europe. So, the European stress test results are partly better because we have gone through the worst of the crisis. And the issue here was really to clear out the banks, the banks that hold a lot of bad debt and too little capital.

Steve Weisman: The European banking system may have been through the worst of the crisis but they still have a sovereign debt problem hanging over them. And did the stress test take that into account?

Anders Åslund: Partly, it has taken into account for what is on the trading books but not on the banking books.

Steve Weisman: Explain what we mean by that. The banks have two sets of books.

Anders Åslund: Yes. One is what they intend to keep until maturity...and the other is meant for trading. And they specify how much that is. Fortunately, at least in the Spanish case, they have specified how much is in which book for all the sensitive government bonds. So we have the additional information and undoubtedly now, there will be various investment banks and consultants who will use all this information that is already available and make alternative stress tests. And we have the most information about Spain and Germany, and these are the two most sensitive countries. Obviously the serious issue of these two is the Landesbank, the regionally state-owned banks in Germany. And the strange thing was that none of them failed the stress test. And there was an expectation [that] they would—several of them would—but the capital of them are just over limit. So one inevitably gets the suspicion that perhaps they have adjusted the criteria so that this Landesbank would manage to pass—

Steve Weisman: But nobody is going to be fooled, you're saying.

Anders Åslund: Yes. That's the essential thing. So it will take a few days for relevant analysts to figure out what the situation is because the information is out now.

Steve Weisman: So these stress tests could succeed by falling short, in a funny way?

Anders Åslund: Yes. You can say that. But the important thing is that we have the information out so that people can pass a clear judgment of their own. And in a way, that was the most important thing about the American stress test as well. And we have pretty much the same criticism of the American stress test that they were too soft. And it turned out that was not the case. But, of course, we are in a different macroeconomic situation today than we were a year ago.

Steve Weisman: Is there anything that was surprising to you about the results? And if it turns out that the American banking system, which is more concentrated, is somehow more stable or solvent than its European competitors, is that going to have an effect on the global competition among banks, between European and American banks?

Anders Åslund: Basically I think that it's good to get the facts out, because it is the bad banks that are drawing down the reputation of better banks. And this should strengthen the European banks in the longer term.

Steve Weisman: Will we see bank consolidation as a result of this?

Anders Åslund: I presume so. We will definitely see that Spanish cajas or savings banks will decline to about half—there's a merger process going on among them already. The big question in terms of the European banking system is really what will happen to the German Landesbank. And you can say that it's an advantage now that the federal government of Christian Democrats does not control many of these regional governments; therefore, they do not care very much about the region or the state banks. And this might actually facilitate the political process of doing something with Landesbank. And so the short of it is that in terms of the banking structure in Europe, this brought out what we had expected. The problem is in the Spanish saving banks and in the German state banks.

Steve Weisman: What implication does this have for European recovery?

Anders Åslund: It will help it because it will improve confidence. We saw in the United States, the big stock market rush started two months before the stress test, but it was very much helped by the banks' stress test. It will give more confidence toward all kinds of financial activities.

Steve Weisman: Anders, thank you.

Anders Åslund: Thank you.

