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EU bank stress tests

Full picture of banking sector health missing due to flawed assessment

Commenting on the results of the stress tests of European banks, released today by the European Central Bank, Greens/EFA co-president **Philippe Lamberts** said:

"While these new stress tests of European banks are an important milestone for EU banking regulation and financial sector transparency, major shortcomings remain in the analysis. We are still lacking the full picture on the health of Europe's banks due to the flawed assessment methodology used by the ECB. This will necessarily hamper efforts to effectively assess the true risk in the sector, with a view to ensuring effective regulation.

"Basing the stress tests on a capital benchmark that still relies on regulatory risk weights masks the situation on bank risks (1). It leaves room for banks to game their risk-weighted assets, which allows them to meet regulatory capital requirements without necessarily reducing economic leverage.

"The narrow focus of the tests, which are conducted on a bank-by-bank basis, prevents a comprehensive assessment of the systemic risks resulting from the high interconnection of the EU banking system. European banks not only show high levels of equity cross-holdings (which hampers the loss-absorbing capacity of the industry as a whole), they also continue to be too much dependent on unstable short-term wholesale funding.

"The launching of the comprehensive assessment by the ECB has by itself provoked a 'spontaneous' recapitalisation of European banks to the tune of €120 billion, which to some extent explains the relatively mild conclusions of the whole exercise. This speaks volumes about the leniency of the national supervisors towards the banks that they so cosily had under their watch hitherto.

"The stress tests could have been much more effective if they had been based on more comprehensive capital requirements (for example, by using the simple leverage ratio), but also if they had looked at the interconnection of European banks. While today's stress tests have shone the spotlight on some of the weakest sections of the banking sector, this should not divert attention from the need for decisive structural reform of the banking industry. A clear-cut separation of banking activities is of vital importance to reduce systemic risks by making banks less complex, less interconnected and more resilient to financial turmoil. This must be a top priority for the EU."

(1) The ECB tested is banks' core capital ratios, which have to amount to at least 8% of their risk-weighted

assets. This means that the relevant estimations are being partly made by the banks themselves, which encourages them to use internal risk models that give the rosier picture of their risks. Instead of relying on risk models, a more robust assessment should have used 'hard', non-probabilistic measures of risks - such as the leverage ratio.

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Philippe Lamberts

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