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Stress test: transforming the ECB in 2014

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Summary

In 2014 the European Central Bank (ECB) will take on one of the biggest and most complex banking supervision roles in the world. For the ECB this is an institutional, cultural and political transformation. It faces the double challenge of doing it when the Eurozone banking system is in poor shape, and when that banking sector weakness is undermining the ECB's other core role in setting monetary policy. Three big practical tasks lie ahead in 2014, culminating in a stress test of Eurozone banks. The problem for the ECB is that it is undertaking this massive practical task with its credibility as yet untested and a political mandate that is ambiguous at best. For investors, creditors and customers of Eurozone banks how the ECB navigates this problem will be one of the big stories of 2014.

In November this year a new Single Supervisory Mechanism (SSM) for the Eurozone will be established with the European Central Bank (ECB) at its core. The ECB will supervise the largest 128 banks directly – including giants like Deutsche Bank, Santander, BNP Paribas and Intesa Sanpaulo - and oversee the supervision of thousands of smaller banks by national competent authorities. Led by Danièle Nouy, who will chair the ECB's Single Supervisory Board (SSB), it will recruit around a thousand additional staff.

For the ECB this is an institutional transformation but also a cultural and a political one. The ECB is taking on one of the biggest and most complex banking supervision roles in the world. It faces the double challenge of doing it when the Eurozone banking system is in poor shape, and when that banking sector weakness is undermining the ECB's other core role in setting monetary policy. Looser monetary policy works by making it cheaper for banks to lend, yet credit growth has been weak in the Eurozone for some time, especially in Spain, Italy and Portugal (Fig. 1). Lower demand by households and firms is partly to blame. But it is also because weak banks with impaired balance sheets, particularly in countries with weak sovereigns, are reluctant to lend or pass on lower borrowing costs to their customers.

This is what Mario Draghi means when he says the Eurozone must repair the transmission mechanism of monetary policy. It requires a clean-up of the banking system to strengthen the banks and this will be the SSM's first task. The problem for the ECB is that it is undertaking this massive practical job with its credibility as a supervisor as yet untested and a political mandate that is ambiguous at best. For investors in, or creditors of, the Eurozone's largest banks, or anyone who banks with one of Nouy's weaker charges, how the ECB navigates this problem is the big story of 2014 in European banking.

Not being the EBA

If the ECB's basic test in 2014 is establishing supervisory credibility, the experience of the European Banking Authority (EBA) is at the front of its mind. The EBA was established in 2009 as one of three new European-level financial regulatory agencies. The EBA is responsible for harmonizing the rulebook for prudential regulation across Europe. It also oversaw two stress tests of European banks in 2010 and 2011 to determine their basic health.

The problem for the EBA has been politics and resources. It has never quite resolved the problem

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of how its role overlaps with that of the European Commission. In part this is a legal issue of how much power the Commission can actually delegate to European agencies – a question that the UK government is still testing through the ECJ. But there is also an element of institutional politics in the Commission's desire to keep the EBA on short leash. European states – especially the UK – have hardly warmed to the new regulator either. It is thinly resourced and heavily dependent on national supervisors for both data gathering and muscle with the banks it deals with.

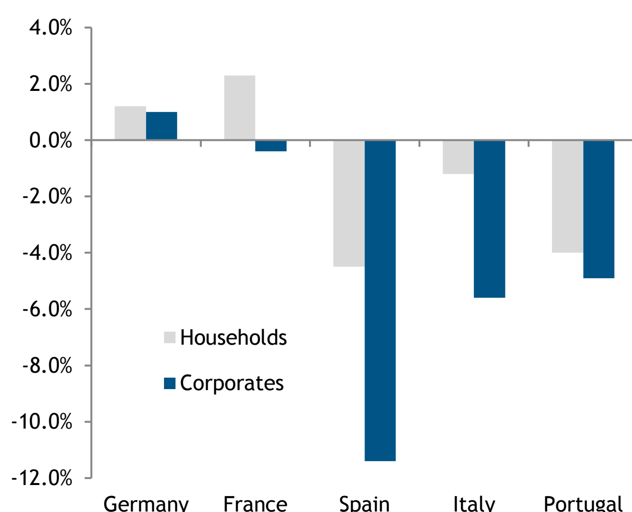

Fig. 1: Growth of outstanding loans during 2013, by recipient sector
Source: ECB

This was the root of the perceived flaws in the 2011 stress tests. National supervisors often lack the required incentives to be honest about the problems their banks face. Pressured by governments reluctant to pick up the bill for banks in crisis and sensitive to their own pre-crisis record, national supervisors gave the EBA a picture of bank health that helped produce results that were doubted on delivery and derided in retrospect. EBA-led stress-tests in 2011 identified a combined capital shortfall of just €2.5bn across the EU, well below the estimates of the IMF and independent analysts. This was quickly followed by high-profile bank failures in Spain, Cyprus and Belgium – an outcome the EBA could not credibly argue it had predicted.

This is the backdrop for the ECB's institutional transformation into a banking supervisor. It is why the officials who will lead the SSM reject any suggestion that the ECB will provide strategic and policy leadership while leaving national supervisors to manage day to day interaction with banks. There is every sign they will seek to exercise full hands-on control as soon as they assume legal responsibility in November. Even before then the ECB faces a key test to establish its credibility as an independent supervisor.

That test, billed by the ECB as its 'comprehensive assessment' of banks, has three parts. The first of these is a supervisory risk assessment that will provide a snapshot of individual bank balance sheets to identify the main risks and potential shocks they are exposed to. The second is an asset quality review (AQR) that will look in detail at the valuations and exposures of all assets held by banks, including sovereign debt, bad loans, and other hard-to-value assets. The ECB has said that it will pay particular attention to shipping, real estate and SME credit and that both on and off-balance sheet positions and market exposures will be included.

Third, and perhaps most significantly, new stress tests will be conducted in coordination with the EBA. These tests will examine the resilience of banks' balance sheet to both a baseline and an 'adverse' scenario over a three-year horizon and look at bad debt, market valuation, wholesale funding, sovereign and securitisation risks. If a bank's capital falls below required levels at the end of the three-year horizon then remedial action will have to be taken. The threshold for Common Equity Tier 1 capital will be 8% of risk-weighted assets in the baseline case, with a requirement that banks could weather an adverse scenario without falling below 5.5%. A capital shortfall under the baseline scenario will need to be plugged promptly, whereas adverse scenario weaknesses will be subject to longer-term capital raising plans agreed with the ECB.

Many Eurozone banks have been cleaning up their balance sheets in anticipation and many have been shrinking their balance sheets to flatter the size of

their capital cushions. From April to October last year, Eurozone banks shed 9 per cent, or €3.3tn, of total assets, according to the ECB. This balance sheet contraction may be one reason why credit growth in the Eurozone has been so weak in 2013.

How much this pre-emptive action will shore up Eurozone banks remains to be seen, although it is expected to help. The outcome of the AQR is easier for banks to predict than the stress tests, as the scenarios that will be used will not be published until April. At the end of the process the banks that still require capital will have to raise it in the financial markets, or reduce the size of their balance sheets further. If they cannot do either they can fall back on reluctant government support. But in doing so they will need to meet the new European conditions for state aid to banks, which impose large-scale writing down of equity and certain classes of debt.

Tough being tough

This exercise seems to provide ample scope for the new SSB to demonstrate its rigour and credibility. For the sake of its own standing the ECB will almost certainly want to require some - and perhaps many - banks to improve their balance sheet positions. The head of the SSB Danièle Nouy has spoken openly about the need for orderly resolutions and she has not yet indicated any obvious anxiety about taking unpopular choices. She has talked about limiting national flexibilities in the implementation of financial regulations through the kinds of “national options” that are still written into draft EU bank recovery and resolution laws.

Nouy has also indicated that she is inclined to end the long-standing practice of treating holdings of sovereign debt by banks as risk free, a practice which remains embedded in global Basel III standards but which was wildly discredited by events after 2008. Berlin has also endorsed this view but it would cause major problems for some weaker banks and sovereigns where the mutual dependency is high. It would also require an objective system of rating the risk of sovereign debt, as Eurozone states would never allow the ECB simply to depend on the judgements of ratings agencies. It may end up being fudged as just too difficult to do now.

The obvious question is just how tough it will be for the ECB to be as tough as it wants. None of Nouy’s judgements will be made in isolation or without influence from national capitals. The authorities in countries like Italy, which are enjoying the first signs of a return of market confidence, will not welcome a public shaming of their weaker banks. Nor is Nouy’s own supervisory board likely to be as technical and dispassionate as she would like. There will be a mixture of hawks – pushing for greater discipline and tighter supervision – and doves, particularly among the 18 heads of the national supervisors, whose approach will inevitably reflect the politics of banking in their national capitals. How these tensions play out, and how much room they leave for Nouy to do her job will in many respects define the ECB’s launch as a banking supervisor.

The other basic constraint on Nouy and the SSB may be money. The corollary of a meaningful stress test is a meaningful capacity for Eurozone banks to be recapitalised or resolved, either by the market or government. The theoretical counterpart of the SSM is a Single Resolution Mechanism (SRM) which was agreed at the end of 2013 with common rules for resolving banks but only a limited and deferred prospect of the pooling funds to support banks or bridge the costs of their resolution where this is required. The ECB’s problem is that the 2014 stress tests are implicitly backed not by the balance sheet of a single Eurozone government, but by the limited resources of individual Eurozone states, the weakest of whom in many cases host the weakest of the banks. Nouy knows that the market believes that she is unlikely to describe a hole in bank balance sheets that is bigger than the resources available to fill it.

It remains to be seen whether the ECB can navigate this problem with its credibility intact. For investors in Eurozone banks or holders of their debt – including corporate depositors – a tough and credible ECB bank supervisor is without doubt a good thing in the long run. If and how that

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credibility is established, and at what cost for existing equity and debt holders – and for confidence in the Eurozone as a whole – will be the European banking story of 2014.

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