Stress test whitewash of European banks

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26 July 2010

The keenly awaited report on the stress tests of European banks, made public Friday by the Committee of European Banking Supervisors (CEBS), amounted to a whitewash of the major financial institutions. The CEBS delayed the release of its report on the balance sheets of 91 European banks until after the close of European markets.

The report declared that just seven European banks had failed the stress tests, a figure much lower than the 10-15 banks predicted by many analysts. Just one German bank, Hypo Real Estate (HRE), failed the test, plus five Spanish savings banks and one Greek bank.

The European bank stress tests followed the example of those carried out last year in the US. The Federal Reserve Board conducted similarly rigged tests of major American banks to reassure the markets and give the banks a clean bill of health.

Prior to Friday's publication of the European test results, one senior market analysts declared, "If HRE is the only [German] bank that fails, that completely discredits the tests—not just for Germany, but for all of Europe." Following the threat of bankruptcy in 2008, HRE was nationalised by the German government and received an injection of funds amounting to over 100 billion euros.

A week ago, analysts were estimating that between 50 billion and 100 billion euros would be required for the recapitalisation of banks that failed the stress tests. According to the CEBS, however, a mere €3.5 billion in additional capital was needed to stabilise the seven failing banks.

Stress tests had been planned a year ago for just 25 European banks, with the results to remain confidential. Then the Greek debt crisis exploded earlier this year, spreading rapidly to other European countries such as Spain and Portugal. With the very existence of the euro at stake, European leaders and the International Monetary Fund agreed on a 750 billion euro fund to guarantee the sovereign debt of Eurozone countries and stabilise the common currency.

Following considerable pressure from American and Asian financial and political circles, which demanded assurances for their investments in the Eurozone, European authorities reluctantly agreed to undertake stress tests for a total of 91 European banks.

It is now clear that the banks themselves largely determined the parameters of the stress tests. According to a report last week in *Der Spiegel*, the 14 German banks being tested were told they had "little to fear because the criteria for the tests were watered down in hectic negotiations between the European Central Bank, the European Commission and European banking watchdogs."

Following the publication of the test results, the *Frankfurter Rundschau* was scathing in its assessment. In an editorial, the newspaper wrote, "Nominally, stress tests were supposed to demonstrate European banks are stable. Instead, they have mercilessly revealed the impotence of the European banking authority."

The newspaper noted that the Committee of European Banking Supervisors has a staff of just 25 employees and was "simply overwhelmed by the Herculean task" of evaluating 91 banks. National banking authorities proved to be dysfunctional. The German Financial Services Authority sent a letter to the heads of the 14 German banks involved in the exercise requesting estimates of the share of equity capital they needed to pass the test and pacify the markets.

"It's like asking bandits to improve policing methods," the newspaper concluded.

Financial experts have criticised the stress tests for other reasons besides the fact that the banks themselves supplied investigators with data on their balance sheets. The CEBS based its tests on a scenario in which Europe fell into recession for two years, with stock markets declining by 20 percent. The tests did not take into account the possibility of a state, such as Greece, defaulting and reneging on its debts.

Moreover, the tests applied only to the funds held in a bank's trading ledger and not to the totality of its books, permitting a firm to shift funds from one set of books to another. The International Monetary Fund declared last week that it did not regard the CEBS tests as sufficiently stringent.

Stephen Pope, market strategist at Cantor, remarked, "I see nothing stressful about this test. It's like sending the banks away for a weekend of R&R." According to VTB Capital economist Neil MacKinnon, "It looks like a whitewash and the initial reaction is one of skepticism on the part of the markets."

European authorities hailed the tests as proof of the strength of the continent's banking sector. In fact, over a third of the banks examined are still dependent on government funding. The CEBS review found that 38 of the 91 banks rely on continued government support of €170 billion.

Following the financial crash of 2008 there was much talk in European financial and political circles of the need for institutions with the power to ensure that such a disaster could not happen again. The CEBS report reveals that for the major shareholders and investors, nothing has changed. They have been given a green light to continue business as usual, secure in the knowledge that they can rely on further government bailouts to cover their gambling losses.