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On the EU Bank Stress Tests

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By ruling out the effect of sovereign default on banks, the EU is ruling it out as a cause.

Markets haven't reacted much to the announcement of results of the stress-testing of Europe's banks. And why should they have? They've been well leaked, and therefore well anticipated. The upshot, on the face of it, would seem to be a whitewash of sorts -- it all just feels too good to be true. The "adverse" testing scenario entailed only a 2% GDP drop, no sovereign defaults were modeled, and mark-to-market losses on sovereigns were reflected only on trading books, not in hold-to-maturity portfolios. Only seven banks out of 91 failed -- five Spanish, one Greek, and one German (which was already under government care-taking). Collectively, the seven require only €3.5 billion new capital.

But before we dismiss this as a mere public relations exercise, let's go back to basics. The key *causal* issue in Europe is the unsustainability of sovereign debt in non-core countries. A default would lead to the *effect* of systemic bank failures, due to extensive bank holdings of sovereign debt, and extensive cross-holdings of each other's debt. The EU ruled out the *cause* when it created the European Financial Stability Facility on May 10 (see "Europe Gets *le TARP*" May 10, 2010). So why should the stress-tests examine *effects* under a scenario the causes of which have been ruled out? Indeed, as we pointed out two weeks ago, the very fact that this scenario is going unexamined can be understood as an implicit recommitment to supporting troubled sovereigns (see "Europe Gropes toward Stress-Tests" July 12, 2010). The whole exercise, carried out as it has been in an opaque and *ad hoc* manner, can be seen a creating a "demand effect" on the EU to deliver as a reality the rosy story told in these tests.

Bottom line

Today's stress tests may seem like a mere public relations exercise, having excluded sovereign default from the "adverse" scenario. But this reveals and entrenches the EU's commitment to rule out sovereign defaults. We still think that commitment may have to be tested, considering the opacity of its terms. But our baseline scenario remains that non-core sovereigns should be strategically assumed to have implicit German credit quality.

Update to strategic view

EUROPEAN BONDS: Today's stress tests may seem like a mere public relations exercise, having excluded sovereign default from the "adverse" scenario. But this reveals and entrenches the EU's commitment to rule out sovereign defaults. We still think that commitment may have to be tested, considering the opacity of its terms. But our baseline scenario remains that non-core sovereigns should be strategically assumed to have implicit German credit quality.

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Key documents

CEBS Stress Test Summary Report

CEBS Summary of 91 bank-by-bank results

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