Nicolas Veron

An Encouraging Start for the ECB's Big Bank Review (October 24, 2013)

The European Central Bank (ECB) just announced its planned review of the largest banks in the euro area, before assuming direct supervisory authority over these banks in early November 2014. (March 1, 2014, had been initially envisaged as the date for this transfer of authority from the national to the European level, but various institutional squabbles have delayed it by eight months.) This communication marks the concrete start of a yearlong review process that will be the make-or-break test for Europe's banking union, which itself is arguably the most important structural change the crisis has prompted in Europe so far.

The ECB's announcements do not have any major surprises, but they help clarify the review process. To echo Article 33.4 of the EU Single Supervisory Mechanism Regulation, the legal basis for the new supervisory role of the ECB which is expected to be published in final form within two weeks or so, the exercise is called Comprehensive Assessment, a bland label that will probably not end the minor semantic confusion that has affected it. Many market participants like three-letter acronyms and refer to it as the AQR (Asset Quality Review), while others use the term "stress tests" to echo the spring 2009 Supervisory Capital Assessment Program in the United States and the successive (and ill-starred) rounds of capital simulations conducted in 2009, 2010 and 2011 in the European Union. In fact, the AQR and stress tests will be two separate components of the Comprehensive Assessment, which will also include a third one called "supervisory risk assessment." The latter is still loosely defined for now, but appears to focus on liquidity and funding patterns.

The Comprehensive Assessment will be conducted over the next 12 months. This is a very long period of time for such a market-sensitive process but is justified both by the large scale of the endeavor (the ECB describes it grandly but aptly as "the largest such exercise ever undertaken in terms of the number of banks, their overall size, and geographical reach") and by the lack of prior supervisory experience at the ECB. The AQR will be based on balance sheets as of end-2013, an early cutoff date that is welcome as it reduces the risk of aggressive credit contraction by banks over a long period of time, which would have weighed negatively on European growth. The ECB will use an 8 percent threshold for the minimum capital requirement, corresponding to the 7 percent reference of the Basel III Accord (4.5 percent so-called core equity tier one capital + 2.5 percent so-called conservation buffer), plus a 1 percent surcharge as all banks are considered of systemic importance. This is a reasonable yardstick for capital adequacy, and marks an acceleration of the long Basel III transition period as enshrined in the European Capital Requirements Regulation. In addition, the ECB will introduce a leverage ratio, also in reference to Basel III but in anticipation of EU legislation.

The ECB has published a tentative list of 124 banks to be reviewed, which it reckons represent an aggregate 85 percent of the euro area's total banking assets; 18 of these are local subsidiaries of non-euro-area banks (from Canada, Denmark, Russia, Sweden, Switzerland, the United Kingdom, and the United States). The list also includes a few government policy banks such as France's new Banque Publique d'Investissement and Germany's KfW IPEX import-export promotion bank; financial arms of carmakers (PSA Peugeot Citroën, Renault, and Volkswagen); two subsidiaries of financial infrastructure firms (LCH.Clearnet in France and Clearstream in Luxembourg); and 15 banks that were nationalized during the crisis (including Allied Irish Banks, ABN Amro, Bank of Cyprus, Bankia, Dexia, and Hypo Real Estate). The other names on the list illustrate the diversity of bank governance models in Europe. More than half of them are cooperatives and national or local government-controlled banks, including savings banks; of the remaining ones, which can be considered commercial banks, many have a controlling shareholder, leaving relatively few in the sample (but several of the largest) as publicly listed companies with dispersed ownership, the dominant model in the United States and United Kingdom. This is one more reason why the political economy of Europe's banking sector is so different from that in the United States.

Most importantly, the ECB's announcement confirms that this will be a markedly different process from the 2010 and 2011 stress tests, and potentially a much more credible one. The European Banking Authority (EBA), which directed the 2011 round, did all it could to ensure a rigorous and consistent assessment, but it had no mandate to impose its demands on reticent national authorities. By contrast, next year's review will be conducted by the ECB itself, of course with help from national supervisors but with its own supervisory staff, direct access to information from banks, and additional help from private-sector consultants, some of which (such as Oliver Wyman) will report directly to Frankfurt and not national capitals. National authorities will not be able to veto consideration of some issues, in contrast to the 2011 exercise, when they could raise so-called red flags. Recent communication by Eurosystem officials indicates that the final recommendations (to the ECB's still-to-be-formed Supervisory Board, which itself will be placed under the authority of the existing Governing Council) will be made solely by ECB staff, rather than on the basis of consensus-dependent committee decisions. If national authorities disagree, their position will be reported to the Supervisory Board, but only as a dissenting opinion.

Even so, the 2014 review raises monumental challenges. The key reason is that the assessment by the ECB is by definition only part of the action. The other part is that, if some banks are found undercapitalized to an extent that could not be corrected only by raising money from market investors, these "problem banks" will need to be restructured (recapitalized, taken over, sold, or resolved) by public authorities. The previous steps taken during the European financial crisis since mid-2007, not to mention earlier European episodes or the parallel experiences in the United States and elsewhere, have amply illustrated how difficult and contentious such government-led bank restructuring could be. It is widely suspected that the number of such problem banks is probably in the double digits and that the corresponding financial shortfall could be very large, possibly higher than 100 billion euros.

To finance these future operations to which the ECB refers euphemistically as "corrective measures," in cases where market investors would not be willing to step in, forced losses (for which the clumsy but now-fashionable euphemism is "bail-in") may be imposed on junior and perhaps also in some cases senior creditors. But in certain scenarios of systemic contagion risk, one cannot rule out the need for some funding from the public purse. Following a decision in June, the European Stability Mechanism (ESM) essentially will not play a significant role in such cases, at least outside of countries under an assistance program, such as Greece or Cyprus (Ireland and Spain are expected to exit their current assistance program shortly; the case of Portugal is more uncertain). As a consequence, resources may have to be found in national budgets, for which the current ECB jargon is "backstops." A minor controversy in July between the ECB and the European Commission on the specific cases of solvent but slightly undercapitalized banks, which was revealed a few days ago, illustrates the ECB's skepticism about an excessive recourse to bail-in, which may correspond to the prevailing political mood—particularly in Germany—but would swing the pendulum too far compared with the European's near-systematic recourse to public bailouts in the first five years of this crisis.

All this sets the stage for a politically complex series of choices to be made in 2014 to prepare for the consequences of the banks' assessment by the ECB. Some member states, including the largest, might push for "forbearance" (i.e., hiding the bad news) for fear of the political and financial consequences of publicly led bank restructurings. The ECB has strong incentives to resist them. Its credibility is at stake, not only as a supervisor but more broadly as a European institution, with possible spillovers to its reputation as a monetary policy authority. The sad precedent of the EBA, whose reputation never fully recovered after it gave a clean bill of health in July 2011 to banks such as Dexia and Cyprus Laiki, which collapsed shortly afterwards, can only reinforce the ECB's determination not to follow the same path. Germany, here as elsewhere, will be in a pivotal position. On the one hand, it is a natural defender of the ECB's integrity and has enough heft to take responsibility for the euro area as a whole. But on the other hand, its banking system is notoriously politicized, and some banks might be in a sorry state (all *Landesbanken* are included in the ECB's assessment list). Furthermore, the consequence of large bank restructurings in, say, Italy or France may create domestic difficulties for the German government as well. To top it all, the European Parliament election of May 2014 may trigger unpredictable political interferences in the midst of the assessment process, especially if, as opinion polls currently suggest, it marks an unprecedented setback for most of the euro area's governing parties, at least outside of Germany.

The 2014 bank review thus presents a choice between two diverging scenarios. In the first, "forbearing" scenario, the ECB would yield to the political pressure from member states, and do little better than the EBA did in 2011 in terms of rigor and consistency of the assessment. The ECB would avoid flashpoints, but the "zombification" of the euro area's banking sector would continue, with a heavily negative impact on Europe's future growth. In the second, "rigorous" scenario, the ECB would resist the pressure for forbearance and expose a number of problem banks, whose restructuring will involve some public cost and political turmoil. But the corresponding cleanup would gradually lift the drag that dysfunctional credit allocation has put on European growth since mid-2007. Furthermore, only in the "rigorous" scenario can the Single Supervisory Mechanism be established on a sound basis, which is a necessary condition for further successful steps towards banking union, itself an indispensable (though not sufficient) component of an eventual resolution of Europe's current predicament. Alas, it is difficult to imagine that the assessment would be rigorous and not expose a number of significantly undercapitalized or insolvent problem banks, some of which quite large. If all were already well in the European banking system, these disclosures would already have happened and investors would have been reassured long ago. It is also difficult to imagine a happy middle ground between the two above described scenarios. The ECB can probably not sugarcoat the assessment's results sufficiently to avoid painful restructuring, while preserving its credibility.

Thus, the conflict between the ECB and member states will escalate. It is likely to trigger significantly more financial-market volatility in 2014 than Europe has witnessed (so far) in 2013, in spite of sizeable internal shocks this year such as the February election in Italy and the March developments in Cyprus, and external ones such as the turmoil in emerging markets and the recent US fiscal drama. If the assessment is lax, the risks are a major loss of ECB's reputation and thus further weakening of an already fragile euro area and European Union, which would be compounded by a final loss of hope in Europe's ability to address its now many-years-old banking problem. By contrast, if Europe's leaders choose the more rigorous option, they have the opportunity to allow trust to return to Europe's banks and pave the way towards a much more resilient financial system. They will need to be clear-sighted about the consequences of their choices in the weeks and months ahead.

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