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Europe's Stress Test

Following the close of European financial markets on July 23, 2010, the Committee of European Banking Supervisors (CEBS) released their much-anticipated stress tests on European banks. As analysts brewed coffee for a long weekend of reading, the U.S. stock market rose, tipping off journalists to put a positive spin on the results. But for investors whose time frames are measured in years rather than hours, it's worth considering the broader messages of the stress tests both for European financial markets and the European economy overall.

Notes on the tests

First, some basics. The 2010 stress tests were conducted by CEBS at the behest of European governments. In 2009, the same group ran more limited stress tests, but the 2010 tests were very comprehensive, covering 91 European banks. All told, these banks account for 65% of total bank assets in the European market, but they also account for at least 50% of total bank assets in each of the 27 member nations of the European Union.

The key variable tested was Tier 1 capital as a percent of risk-adjusted assets. European Union regulations require that this ratio be at least 4%. As a practical matter, no one believes that 4% is adequate - across these 91 institutions, the average ratio was actually 10.3% at the end of 2009. As a result, the threshold for "failing" the test was instead set at 6%.

Two scenarios were considered using the end of 2009 as a starting point and looking out over 2010 and 2011 - a benchmark scenario and an adverse scenario that included a double-dip recession. This latter scenario was further worsened by assuming a big spike in the yields on sovereign debt, assuming an increase in sovereign debt fears, but not an outright default.

So how did the tests work out? According to CEBS, only seven of the 91 banks failed the test, or, in other words, would have had a Tier 1 capital ratio below 6% by the end of 2011. These included one bank in Germany, one bank in Greece and five banks in Spain. All told, the total shortfall of these banks was judged to be €3.5 billion under the adverse scenario, which, given that the 91 banks had total assets of €28 trillion at the end of 2009, seems like a mere pittance. CEBS noted that national authorities are working closely with these seven banks to determine how to recapitalize them; however, in broad terms, the European banking system can be said to have passed the tests with flying colors.

How tough were the tests?

So far, so good. But given that markets appeared to be bracing for much worse news, the next natural question must be: Just how tough were these tests?

Overall, the benchmark scenario seems to have been pretty conservative. It assumes, for example, that Eurozone economic growth is just 0.7% in 2010 and 1.5% in 2011, and that the unemployment rate, which averaged 10% in the Eurozone in the first quarter of this year, averages 10.7% for the whole of 2010 and 10.9% in 2011. It also assumes that European and global stock prices fall by 10% over 2010 and 2011, which would mostly implying stock prices flatlining or drifting down from here.

Evolution of aggregate key macro-economic variables in the scenarios

	Realized			2010 Exercise			
	2008	2009	2010 Q1	Benchmark		Adverse	
				2010	2011	2010	2011
EU27							
GDP(y-o-y)	0.7%	-4.2%	0.2%	1.0%	1.7%	0.0%	-0.4%
Unemployment (% of labor force)	7.0%	8.9%	9.6%	9.8%	9.7%	10.5%	11.0%
Euro area							
GDP(y-o-y)	0.6%	-4.1%	0.2%	0.7%	1.5%	-0.2%	-0.6%
Unemployment (% of labor force)	7.5%	9.4%	10.0%	10.7%	10.9%	10.8%	11.5%
US							
GDP(y-o-y)	0.4%	-2.4%	0.7%	2.2%	2.0%	1.5%	0.6%
Unemployment (% of labor force)	5.8%	9.3%	9.7%	10.0%	10.2%	10.2%	11.1%

Notes: GDP changes for realized is real GDP growth rate, Q1 2010 GDP Growth is compared to Q4 2009

Source: Eurostat for realized figures, stress test scenarios

(Recreated from Table 1 of Aggregate outcome of the 2010 EU wide stress test exercise coordinated by CEBS in cooperation with the ECB)

By contrast, the economic numbers in the adverse scenario might be criticized as not being adverse enough. A double-dip recession is assumed, but it only results in declines in real GDP of 0.2% in 2010 and 0.6% in 2011, compared to the actual 4.1% decline in real Eurozone GDP in 2009. The 10% fall in global stock prices in the benchmark scenario only turns into a 20% decline in the adverse case. In addition, it is assumed that there is no default on any sovereign debt, but rather that the debt gets marked down on banks' balance sheets as the risk of default is seen to have risen.

It must be said, on this last point, that it was probably very wise of the CEBS not to assume default on sovereign debt in any scenario, as to have done so would have only encouraged those looking to speculate against that debt.

Moreover, it could also be argued, in defending the adverse scenario assumptions, that in the initial stages of recovery from a deep recession and deep bear market, economic activity tends to be supported by pent-up demand, while stocks are protected by cheap valuations. However, overall, the modest gap between the benchmark and the adverse scenario does give the impression that the adverse scenario is by no means the worst that could happen.

One last, very important point about any adverse scenario is that it is almost impossible to make any probability statement about it. In terms of the severity of possible outcomes, are 95% of possible outcomes better than the adverse scenario, or 90%, or maybe only 75%? We don't know, and no amount of stress-testing can really tell us, because statistical analysis cannot handle the speed of change in the structure of financial markets or the viciousness of feedback loops across these markets and the economy.

The message of the tests

However, while the stress tests may not enlighten us much about the future, they do contain two important messages about the present.

First, they tell us that in general, the European banking system is currently very well capitalized and has, with a good deal of government help, been healing itself. Halfway through 2010, aggregate Tier I capital appears to be more than adequate and rising, and new loan losses appear to be falling. European economic growth has been stronger in the second quarter than many feared and European banks seem well positioned to deal with the stress coming their way from long-postponed fiscal austerity.

Second, the stress tests, in combination with the emergency actions collectively taken by European governments earlier this year to backstop European debt, and individually to put their fiscal houses in order, show that European nations really can act in a coordinated way during a crisis.

The European Union had its origin in a hope that, by linking their economic fortunes, the nations of Europe would not only prosper, but would also never again wage war against one another. More than 50 years of peace and economic progress has proven this calculation to be correct. However, it is perhaps only now, in the wake of a global financial crisis, a global recession and a collective European sovereign debt crisis, that Europeans have realized how truly intertwined they have become.

Over the last two decades, there have been many times when Europe seemed divided, unable to agree on a constitution, and unwilling to act in a coordinated way on issues like the wars in Bosnia and Kosovo. At times this spring, the same spirit of narrow and short-sighted nationalism led some to argue that Greece and other debt-burdened nations should be left to fend for themselves, or even that the common currency should be disbanded.

Thankfully, wisdom appears to have prevailed, and European governments seem ready to deal with their financial problems together, greatly reducing the risk of another financial crisis. In the end, 2010 may go down as the year of a successful stress test, not only for European banks, but also for the idea of European unity itself.

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