

European Banks: Passing an Easy Test

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Today, the various banking supervisors in the European Union (E.U.) released the results of their banks' stress tests. This is a similar exercise that U.S. banking regulators imposed on 19 large U.S. banks in early 2009. The U.S.'s stress test showed that ten of the 19 banks needed to collectively raise \$75 billion in capital to make the grade. The E.U. results indicated failed scores for seven of the 91 banks. While the U.S. results triggered a relief rally, the E.U. results have not.

Doubts are raised about the tests' usefulness

The first question is whether or not the stress tests were actually stressful. They were designed to simulate what would happen to a bank's capital ratio if the European economy shrinks by 2% in 2010 and 1.25% in 2011. Could the bank survive such a scenario? Because of how vaguely the terms were defined, most investors were probably thinking that all the banks (or the vast majority of them) would pass.

The second question is whether or not the governments will stand behind the banks that failed the tests. In the United States, the implication of the stress tests was that if the banks raised the requisite amount of capital, the U.S. government would pick up any slack. In the European Union, the results are probably being interpreted the same way. Most banks were told they have a clean bill of health, which implies that the governments will back the banks. Of course, the problem in the European Union is that there may not be local governments that are able to back the banks. Those members of the European Union that are part of the eurozone—countries that adopted the euro as their common currency—don't have the same freedom to back their banks like the United States or the United Kingdom does. Thus, market participants might not view the implicit backing of the banks as being very credible.

My big problem with these stress tests is that they may give investors a false sense of security about the health of the E.U. banks. Just because the banks can pass a series of tests that simulate adverse economic shocks doesn't necessarily mean they can survive a more lingering problem. Two years of negative growth is bad, but what about five to seven years of really slow growth? I think investors should tread carefully and not assume these results give the "all-clear" signal.

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