



## Europe's Stress Tests: Not Reassuring

*Morris Goldstein finds that the stress tests announced July 23 indicate a reluctance in Europe to admit the seriousness of the banks' difficulties.*

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Steve Weisman: How reassuring have the European bank stress tests been to those concerned about the stability and health of the European banking system? This is Steve Weisman at the Peterson Institute for International Economics with Morris Goldstein of the Institute, senior fellow here who's been looking at the stress tests that were out today, July 23. Morris, thanks for joining me.

Morris Goldstein: Delighted to be here, Steve.

Steve Weisman: So should we be reassured by these stress tests?

Morris Goldstein: I'm certainly not reassured and I would give you four reasons for that. First, one of the motivations for doing this exercise was the concern in Europe about sovereign debt—particularly Greece, Portugal, Ireland, Spain, etc.—and the fact that the banks are reported to be holding a lot of that sovereign debt, and some of that may eventually have to be restructured, which would have an adverse affect on the banks. What you'd like to know is how much of this debt each bank is holding.

Steve Weisman: Did we find out?

Morris Goldstein: Except for Spanish banks, which seem to have done so at the request of their own authority, we did not get that information. What we got instead was a very partial substitute. They did a scenario under which concerns about default would raise interest rates and could lead to potential losses in what's called the trading book of banks—that is, the assets they hold for trading. But the assets that they hold as a part of the “banking book” are not disclosed. So we don't know either the total amount held or what the potential losses are on the banking book. Hence, on that very crucial issue, it's very incomplete.

Steve Weisman: It's like when somebody says, “No comment,” you are all the more suspicious.

Morris Goldstein: That's right. But this is a key motivation and I think they didn't satisfy that because they didn't come clean.

Steve Weisman: You mentioned a few other factors.

Morris Goldstein: Yes. Second, the standard that they used to see whether the banks are in good shape is to look at the global standard for what is called Tier 1 capital as a share of risk-weighted assets for a well-capitalized bank.

Steve Weisman: That's supposed to be the highest quality of capital—

Morris Goldstein: Well, it's higher than Tier 2. It's not as high as if we just looked at common equity, but I'll come back to that in a minute. It's at least a higher quality than total capital, and the global standard for something that would be called well capitalized is 6.5 percent.

Steve Weisman: Of the assets?

Morris Goldstein: Six percent of risk-weighted assets. So that's what they look at. The problem is that this standard is by now regarded by almost everyone as outdated and inappropriate. In fact, the international negotiations known as Basel III are now attempting to supplant that with a much more rigorous standard. Also, we know that banks are holding much higher ratios of capital than that standard. For example, in the report they indicate that the average for Tier 1 is 10 percent—not 6 percent. And the reasons bankers are holding that is because the market is pressuring them to do so. So the fact that someone might have 6.3 percent or 7 percent isn't very assuring when the average is 10 percent.

Steve Weisman: It's like a kids' soccer team, everybody gets a trophy.

Morris Goldstein: Yes, you use a standard that's now regarded, I think, as inappropriate and is in the process of being replaced. To take an example, the Swiss banking system has just mandated that for its two largest banks they use double the global standards. Everyone agrees that existing standards are not appropriate.

The third reason why it's a problem is the way you measure capital ratios, you have a numerator and a denominator. And again, the consensus as part of negotiations for Basel III is that the way we measure both the numerator and the denominator needs to change. In particular, measurement of capital, what we should be concentrating on is common equity—

Steve Weisman: The highest—

Morris Goldstein: That's the highest quality because that's what absorbs losses. In the crisis, equity holders don't get protected. It's not like preferred stock. It's not like subordinated debt. It's not like the other things that don't have the same loss-absorbing quality. So if you look at Tier 1, in a sense you're overestimating the quality of the capital.

Steve Weisman: And the denominator?

Morris Goldstein: And the denominator is equally a problem. We have risk-weighted assets where we take the assets and we give them various weights depending on the degree of riskiness. The whole point of Basel II was that we found new ways of measuring those risk weights. But those turn out to be completely wrong. That's what we're changing to go to Basel III.

Steve Weisman: But they use the old ones to assess.

Morris Goldstein: They use the existing ones, the old risk weights for the most part. And it's now recognized, for example, that assets that you hold in the trading book should really have a risk weight three times as high as what is the standard now. And there's already been an agreement that as of the end of this year they're going to push that up. Similarly, there [are] a lot of assets that aren't included, that are off balance sheet, that's why there's been a parallel movement to move to something called a leverage ratio, which would be much more comprehensive. So again, where the denominator is too small, the numerator is too big and one shouldn't be reassured by having passed that weak test.

Steve Weisman: You're not reassured. Are the markets going to be reassured? And if they're not, won't that force the banks to raise their capital and do these things on their own? Won't some good come from knowing more as a result of these stress tests?

Morris Goldstein: Since the European authorities fought hard and long to resist doing this publishing, I think the fact that they've done it is at least a step forward. But I'll be surprised, frankly, if the markets buy it. Probably the best evidence we have that the European banking system is weak is that the Europeans, by all accounts, are pushing the hardest to water down the standards for the Basel III capital and liquidity requirements. They have lower capital ratios than US banks on average. They have lower quality capital. And they have much lower liquidity ratios, which is another big problem. And so they're fighting more rigorous standards. So I think that actually is a better test. You have one that is looking for confidence in the European banking system, and they would have been better served by disclosing more and having a more rigorous test.

Steve Weisman: These tests come at a fraught moment and you've worried about these standards being watered down. Could it at least awaken people to the weakness of the banks and make them more alert to the watering down attempt?

Morris Goldstein: I hope so. In that sense, I hope the market will show they have some doubts and this will act as a spur to more disclosure, to more rigorous tests and in the end, to much tougher international rules for bank capital and bank liquidity.

Steve Weisman: US banks generally now adhere to some of these higher standards, as a result of the US stress test. Does that make US banks better off competitively than European banks?

Morris Goldstein: I think the market will come to that conclusion. And to some extent, authorities have done so. Of course, it was spurred in part by the sovereign debt concerns. But I think the position [that] at least some of the industry has taken—namely that we can't have higher capital standards because this will be too expensive and difficult and it will have bad effects on the economy—is very much exaggerated. When you have the higher capital standards you also get higher margins of safety and the market recognizes that and I think pays off on it.

Steve Weisman: The leading association of the banking industry has argued the point [about cost of higher standards].

Morris Goldstein: I think there have been all kinds of reports out there from some of the associations and some of the largest banks, including US banks, that suggest that if we were to move to a very rigorous regulatory reform program, including tougher capital and liquidity standards, we would have terrible effects on loan pricing and on credit extension and on economic growth. Again, I think those claims are vastly exaggerated.

Steve Weisman: What is the likely effect of these stress tests on recovery prospects in Europe?

Morris Goldstein: I think if these are merely the first step to better disclosure and tougher standards, it would be helpful. I mean, the main reason why we're having the [stress tests] is because the Spanish authorities said, "Well, if you don't do this as a group, we're going to do it on our own." And as I've mentioned, the Swiss banking authorities have already come out with tougher tests and with more rigorous stress tests of their own. So I think that eventually, if we get more disclosure than we have at present from today's results, that will be helpful. But if they continue to try [to] keep a lot of crucial information in the dark, and if they go for sort of a very low common denominator, I think that's not going to be helpful.

Steve Weisman: Morris Goldstein, thank you.

Morris Goldstein: Thank you, Steve.

