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Bank stress tests only lift a tip of the veil

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The latest results of the EU-wide stress test exercise conducted by the [European Banking Authority] (EBA) and the [European Central Bank] (ECB) provide a reassuring picture of the health of the European banking sector. After the mid-March market stress, according to the ECB and the EBA there are no reasons to be concerned about the health of the European banking system. But it is all a matter of the parameters of the stress tests and of the granularity of a bank-specific evaluation, which is very difficult to assess based upon the respective reports. It seems that both started from very static assumptions, and that the lessons of the Silicon Valley Bank (SVB) debacle have not been taken into account.

After the turbulence in the US and European financial markets in March, publishing the bank stress test results on a Friday afternoon in the midst of the holiday season raises suspicions. How are European banks doing? What about their exposure to the bond markets in a year of dramatically rising interest rates? Can they cope with fast deposit withdrawals in the internet age? But also, have climate risks and the green transition been considered?

Bank capital positions are strong (15 % for core equity tier 1, CET1), with still 10.4 % in adverse circumstances. The leverage ratio stands at 5.5 %, going down to 4.4 % in adverse conditions. Profitability is steadily increasing with the return of positive interest rates, and will be further boosted by the very generous returns on the deposit facility of the ECB. The smaller banks in the ECB sample (98 banks, 80 % of total eurozone assets) experienced greater capital depletion during stress than the larger ECB-supervised banks, but starting from a higher capital base. Only five banks fell below the 8 % threshold in the EBA tests (70 banks, 75 % of total assets) after a three-year adverse period, and only one (La Banque Postale) ended up with no capital. For the leverage ratio, three banks fell below the 3 % minimum in the same circumstances. As the CET1 is a prudential standard, with a zero-risk weighting for government debt (meaning no need for capital for such securities), the leverage ratio is probably more relevant, although 3 % is low.

The stress tests focus mostly on credit risk and loan losses, operational risk and market risk, with the latter at total losses of EUR 232 billion in the EBA stress test (p. 53) seemingly limited

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over a three-year period in adverse circumstances. For sovereign exposures alone, the loss is EUR 42.5 billion in the EBA sample, which seems limited as well. The ECB published a separate statement on market risk losses. As of February 2023, it showed system-level net unrealised losses for significant institutions directly supervised by the ECB totalling EUR 73 billion. Gross unrealised losses reached a peak of EUR 124 billion in December 2022 and stood at EUR 116 billion in February 2023, but as a result of hedges, net unrealised losses were approximately EUR 40 billion lower.

Neither stress test provides insights on the growth and concentration of deposits or the impact of an eventual rapid withdrawal of deposits. Nor do they provide information on the levels of the liquidity coverage ratio or the net stable funding ratio in the banks supervised. As the SVB bail-out and the Credit Suisse panic showed, even banks that are healthy according to the basic ratios can rapidly turn sick and face a liquidity drain.

The parameters of the stress tests should therefore be broadened. This also applies to climate risk, on which the ECB published a climate risk stress test in 2022, although it did not focus on individual banks, but on specific sectors and bank products. It concluded that 'climate risks are relevant for the large majority of significant institutions directly supervised by the ECB', mostly on the credit risk side, and that the loss could be *at least* EUR 70 billion.

Specifically on the sovereign exposure, the ECB only started raising rates in July 2022, well after the Fed and with an almost similar increase – implying that the losses on sovereign exposures could still grow. Moreover, the total exposure of European banks to sovereigns is much higher than in the US, where sovereign debt is mostly held by the markets (mutual funds and institutional investors). According to the latest transparency exercise, the total sovereign exposure reported by EU banks was around EUR 3.3 trillion in June 2022, implying that a decline of 20 % of the bond portfolio would amount to a gross loss of approximately EUR 660 billion.

Hence, there are more clouds on the horizon. Stress tests have become normal exercises, based on established models. The element of stress in terms of big, unknown exogenous events is notably absent, as are the brown exposures or the impact of social media and digitalisation on bank runs. Real estate markets could also suffer as a result of the steep increase in interest rates and tightening of lending standards by banks. Finally, the unexpected bail-out of a large, systemically important bank in Europe raised plenty of questions about financial stability. Some more out-of-the-box thinking is thus required.

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