International Economics 147 (2016) 126–144

Contents lists available at ScienceDirect

International Economics

journal homepage: www.elsevier.com/locate/inteco

Is the European banking system robust? An evaluation through the lens of the ECB's Comprehensive Assessment ☆, ☆☆

Guillaume Arnould [a,b,*], Salim Dehmej [a,b]

[a] Centre d'Economie de la Sorbonne - Université Paris I (Panthéon-Sorbonne), 106 Bd de l'Hôpital, 75013 Paris, France
[b] Labex Régulation Financière (Réfi), France

A R T I C L E I N F O

Available online 21 April 2016

JEL classification:
G21
G28

Keywords:
Financial stability
Stress tests
Banking
Financial regulation
Basel III

A B S T R A C T

The results of the Comprehensive Assessment conducted by the ECB seem to attest the soundness of the European banking system since only 8 of 130 assessed banks had to raise capital (€6bn) when results were released. However, non-failing banks are not completely healthy. If the Comprehensive Assessment has been a very complex exercise, it has flaws that lead to middling conclusion on the soundness of the Eurozone banking system. Relying on stress tests' literature and an international comparison, we show that the assumptions used for the Asset Quality Review and stress tests lead to weak capital requirements. Using public bank-level data provided by the ECB and the EBA, we address some critics and highlight substantial capital shortfalls due to the transitional arrangements, an implementation of Basel III sovereign debt requirements instead of the zero risk weights applied in Europe and a stressed leverage ratio as a complementary indicator of banks soundness. Finally, we show that the low profitability, the

☆We thank our two anonymous referees, Jézabel Couppey-Soubeyran, Thibaut Duprey, Faith Witryol, Michel Crinetz, Nicolas Véron, Martien Lubberink, Christophe Boucher, Stefanie Schulte and participants of the conferences “Les nouvelles approches du risque systémique” at Besançon on the 30 January 2015, and Labex ReFi on the 12 May 2015, for their helpful comments and suggestions. We remain responsible for any errors and omissions. All data are available upon request.

☆☆This work was achieved through the Laboratory of Excellence on Financial Regulation (Labex ReFi) supported by PRES heSam under the reference ANR-10-LABX-0095. It benefitted from a French government support managed by the within the project Investissements d'Avenir Paris Nouveaux Mondes (investments for the future Paris-New Worlds) under the reference ANR-11-IDEX-0006-02.

* Corresponding author at: University Paris I Pantheon-Sorbonne, 106 Bd de l'Hôpital, 75013 Paris, France.
E-mail addresses: guillaume.arnould@univ-paris1.fr (G. Arnould), salim.dehmej@univ-paris1.fr (S. Dehmej).

http://dx.doi.org/10.1016/j.inteco.2016.04.002
2110-7017/© 2016 CEPII (*Centre d'Etudes Prospectives et d'Informations Internationales*), a center for research and expertise on the world economy. Published by Elsevier B.V. All rights reserved.

massive dividend distribution and the incurred fines, give rise to concern on the ability of Eurozone banks to meet the incoming capital requirements.

© 2016 CEPII (*Centre d'Etudes Prospectives et d'Informations Internationales*), a center for research and expertise on the world economy. Published by Elsevier B.V. All rights reserved.

1. Introduction

On 4th November 2014, the European Central Bank (ECB) became the new microprudential supervisor within the Single Supervisory Mechanism, the first pillar of the banking union.[1] A few days earlier, on 26th October, the results of a comprehensive assessment of 130 Eurozone banks were released, constituting a preliminary step in the ECB's new mission. This assessment[2] was based on an Assets Quality Review, backed-up by a stress test conducted jointly with the European Banking Authority (EBA). Stress tests evaluate banks' capacity to withstand deteriorating economic and financial conditions. They are part of the post-crisis regulatory toolkit and are used in several countries such the US, the UK and in Europe since the recent financial crisis. Stress tests are used both for microprudential supervision and macroprudential assessment of systemic risk and financial imbalances. In the ECB's last exercise, banks' balance sheets faced macroeconomic scenarios, one considered as "baseline" – based on the European Commission's forecasts from early 2014 – and the other as "stressed" – representing worsening European economic conditions. Banks had to maintain their capital risk-weighted ratios (Common Equity Tier 1 (CET1[3]) over Risk-Weighted Assets (RWA)), above 8% and 5.5% respectively for the baseline and stressed scenarios (ECB, 2014).

The exercise revealed a capital shortfall of €25bn for 25 of the 130 assessed banks, on the basis of their balance sheets at the end of 2013. Given the recapitalisation implemented for most of these banks during 2014, only 8 banks[4] had to raise €6bn of capital when results were released. Failed banks – mainly concentrated in Italy – had to submit recapitalisation plans. The fact that none of the major banks failed the test – especially from the "core" of the Eurozone (Germany, Belgium, Netherlands and France) – resulted in high praise for the European universal banking model. Overall, no surprise or worrying situation was noticed. Sahin and de Haan (2016) highlight that banks' stock market prices and CDS spreads did not react to the publication of results.

Nevertheless, concluding to the soundness of European banks is misleading, as the multiple failures in the Italian banking system or the massive uncovered losses of Deutsche Bank in 2016 remind us. In Section 2, relying on stress tests' literature and an international comparison, we document the limits of the European exercise on sampling, methodology and comparability. We show that the sampling was limited to biggest banks while they are not the only financial institutions to bear risks. We review the assumptions used for the Asset Quality Review and stress tests and report their limits that lead to low capital requirements and comparability' issues.

Using public bank-level data provided by the ECB and the EBA in relation with the Comprehensive Assessment and stress tests, in Section 3 we address some of the critics, mainly those concerning the comparability across countries. We reassess capital shortfalls at bank and country levels by calculating the stressed leverage ratio (Tier 1 capital (T1) over total exposures), documenting bank-level sovereign exposures, and taking into account the transitional agreements in the implementation of Basel III requirements. Our analysis allows us to compare the results across countries (by considering a homogenous definition of capital) but also to consider probable regulatory evolutions (such an

[1] The banking union is composed of three pillars: a single supervision, a resolution mechanism and a deposit guarantee scheme (see Véron and Wolff, 2013).

[2] The comprehensive assessment was conducted not only by the ECB but also by the consultancy firm Oliver Wyman.

[3] See BIS (2011) for a definition of CET1 and T1 capital.

[4] Of the 25 banks that revealed shortfalls, 12 already raised sufficient capital during 2014, and of the 13 remaining, 5 are restructuring or have implemented adequate capitalisation plans (ECB, 2014).

Download English Version:

https://daneshyari.com/en/article/999120

Download Persian Version:

https://daneshyari.com/article/999120

Daneshyari.com