

Stressing About Credit Creation, Not Test Results

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Last week's stress test results for 91 institutions, representing two-thirds of Europe's banking system, elicited a sigh of relief among global investors. It wasn't that only seven banks failed with a mere €3.5 bln (US\$4.5 bln) in collective capital deficiency, or that the test itself was foolproof (it wasn't). Instead, investors appeared encouraged by the rays of light shone on previously opaque bank balance sheets. It also helped that some global banks reported strong earnings this week, along with the news that international regulators had watered down their previously draconian recommendations on new bank capital requirements. Nevertheless, as was the case after last year's U.S. bank stress test, investors appear to put a high premium on balance sheet clarity (*Chart 1*).

The stress test results and methodology prompted a cynical reaction from analysts. The small number of failures in the European test stood in contrast to the U.S. test of May 2009, in which 10 of 19 large banks failed and needed to raise US\$75 bln in capital (*Chart 2*). The more negative U.S. results appeared to afford the European test less credibility, although there were cynics of the U.S. test too. Note that the larger U.S. capital deficiency also reflected the fact that the focus was on tier 1 common capital, while European regulators looked at a broader measure of tier 1 capital (most U.S. banks would have fared well using the broader measure).

Criticisms of the European test's methodology were broad based. They included the assertion that the recession scenario was too mild and therefore unemployment didn't rise enough and home prices didn't fall enough, a sovereign credit default scenario was not included, and only trading books were subject to haircuts on sovereign securities. However, European officials insist their stress scenarios were more severe than the U.S. ones. Considering the Euro Area contracted 4.1% in 2009, a double-dip recession scenario with further moderate declines in real GDP in 2010 and 2011 would be a very negative outcome, especially considering positive growth seen through the first half of this year. The U.S. test modelled a 3.3% drop in GDP in 2009, with 0.5% growth in 2010 (so only a deep one-year recession), and the scenarios were publicized well before the test results were released.

CHART 1
INVESTORS LIKE BANK BALANCE SHEET CLARITY

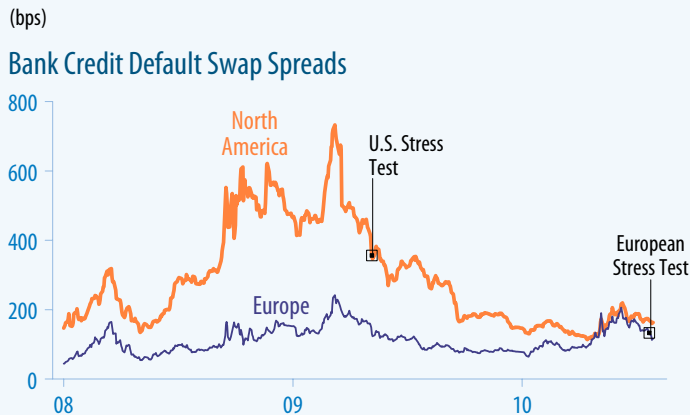


CHART 2
EUROPEAN TEST NOT SO STRESSFUL

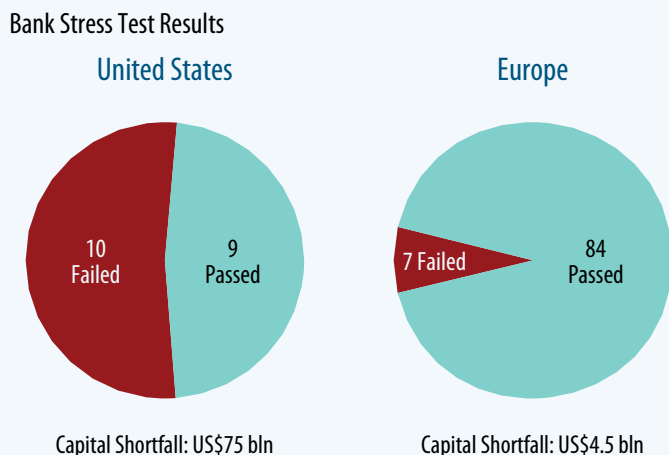


CHART 3
WORST BANK CREDIT CONTRACTION SINCE WWII

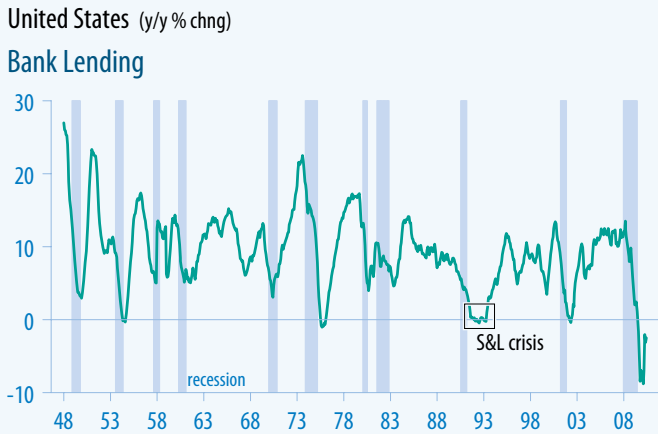
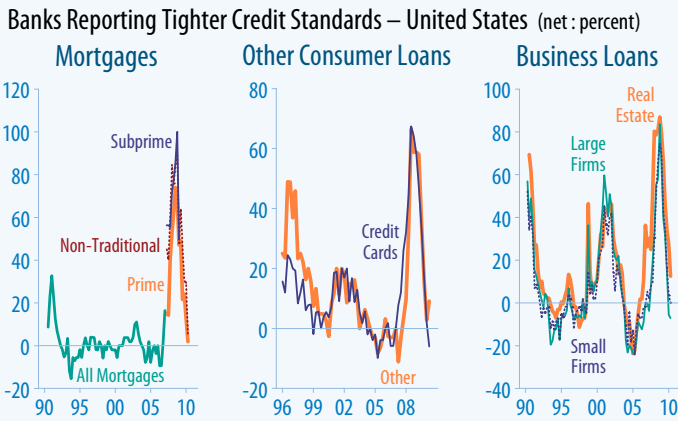
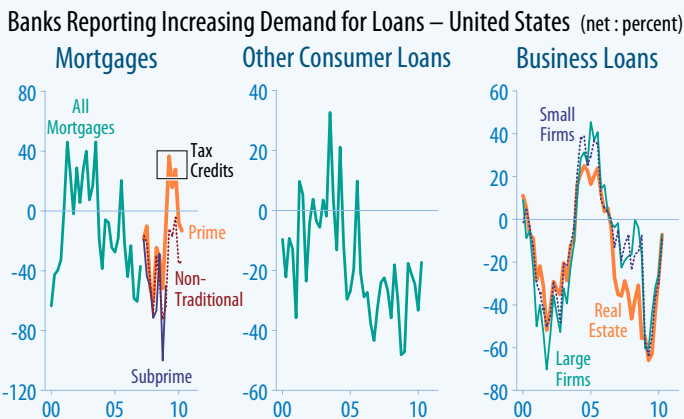


CHART 4
LENDING STANDARDS STARTING TO STABILIZE... AT LOFTY LEVELS



Source: Federal Reserve Senior Loan Officer Survey

CHART 5
CREDIT DEMAND DECREASING ACROSS THE BOARD



Source: Federal Reserve Senior Loan Officer Survey

We judge that excluding a sovereign credit default was not a weakness of the testing exercise. The Greek and pan-European support packages put in place in recent months will guard against this outcome for at least the next couple of years. However, beyond the bail-out period (and well beyond the testing horizon), we believe that Greece might still have to restructure its debt if it can't secure another support package (the penultimate problem with Greece is the sheer size of its debt and the massive primary budget surplus that must be maintained just to pay the interest). As long as meaningful fiscal consolidation continues in the other countries in question (such as Portugal, Spain and the U.K.), this will go a long way in limiting any future sovereign contagion. Meantime, European banks will have a few more years to build even more capital to absorb any potential sovereign debt restructuring.

Since 2007, European banks have raised US\$570 bln in capital vs. US\$565 bln in losses, while U.S. banks raised US\$812 bln in capital vs. US\$1192 bln in losses. Total potential losses in the European test were about 5% of risk-weighted assets or US\$735 bln, less than the 7.7% of risk-weighted assets or US\$600 bln in the U.S. test. However, when added to writedowns already booked, potential European losses would rise above actual losses in the U.S. Recall that the U.S. test was conducted at the height of the global recession, while European banks have had an extra year to heal, which is why the larger potential losses didn't translate into more failures. Moreover, considering the huge losses already taken, future losses aren't likely to be as severe in any adverse scenario (the worst credits have already been erased, although there remains concern that European banks have lagged in writing down their exposures to U.S. real estate).

There is no doubt that favourable stress test results or quick remedial actions to shore up deficient capital go a long way in boosting bank investor confidence, and contribute to lower bank funding costs than would otherwise be the case. But, if banks aren't actively tapping wholesale funding markets owing to a dysfunctional credit creation process, then the entire testing exercise becomes a moot point as far as economic prospects are concerned. This is the case on both sides of the Atlantic.

CHART 6
BANK CREDIT BARELY EXPANDING

Euro Area (y/y % chng)

Loans to Non-Financial Private Sector

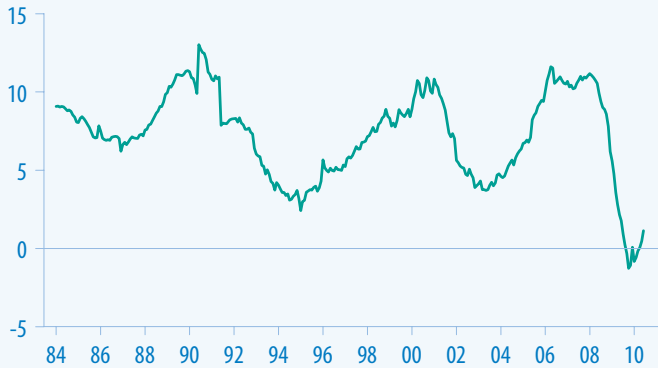
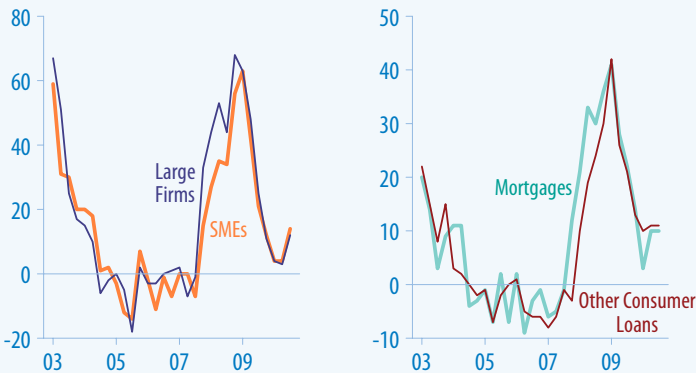


CHART 7
TURNING THE TIGHTENING SCREWS

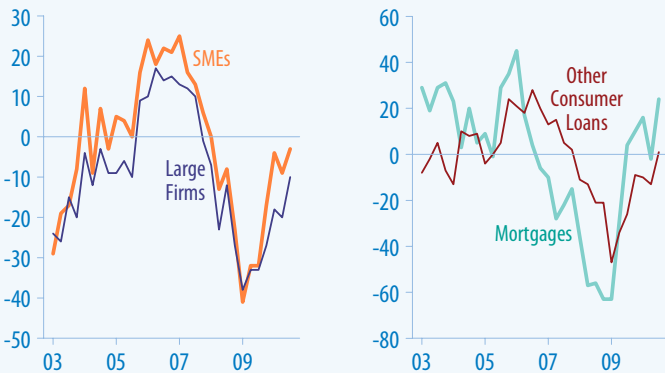
Banks Reporting Tighter Credit Standards – Euro Area (net : percent)



Source: ECB Bank Lending Survey

CHART 8
MIXED CREDIT DEMAND: HOUSEHOLDS UP, FIRMS DOWN

Banks Reporting Increasing Demand for Loans – Euro Area (net : percent)



Source: ECB Bank Lending Survey

In the United States, bank credit continues to contract at a record pace, more than a year after the test results were released (the recent uptick to less negative growth reflects an accounting change that required banks to consolidate loans in off-balance sheet vehicles) (Chart 3). Shrinking bank intermediation reflects factors on both the supply and demand side. Banks are guarding their capital carefully in light of past losses, potential future losses and forthcoming regulatory changes. Only in loans to large businesses (that have access to competing capital market funding) and in consumer credit cards (perhaps reflecting small business migration into this personal product) have U.S. banks even begun to ratchet down their very tight lending standards (Chart 4). Meantime, U.S. banks face a shrinking demand for loans across the board (Chart 5), as balance sheet restructuring and economic uncertainty take their tolls.

In Europe (the ECB’s survey was released this week), bank lending to households and non-financial corporations inched up just 1.1% y/y in June, still hovering in its slowest range since the early 1980s (and after contracting for the first time on record) (Chart 6). Faced with comparable capital issues to U.S. institutions, European banks are still tightening lending standards and, lately, at an upping pace—likely reflecting concerns not only about sovereign credit but also the private sector credit ramifications of fiscal consolidation (Chart 7). However, unlike their U.S. counterparts, European banks are seeing signs of increasing household loan demand (but not among businesses), allowing bank credit to inch up (Chart 8).

Bottom line: The funny thing about stress testing is that you can always construct a more adverse scenario. Individual banks around the world no doubt conduct some pretty extreme scenarios for internal use only. But when looking at an entire banking system, and its inherent diversification of individual bank risk, it’s more appropriate to focus on an array of more probable adverse scenarios. Besides, any debate about stress test modelling diverts attention from the much more serious problem of dysfunctional credit creation. If European regulators were hoping that their stress test would stoke bank credit growth, the U.S. experience would suggest otherwise.

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