ECB’s stress-test: Who are they kidding?

There's a famous saying among financiers: either stress tests are done correctly and banks fail miserably, either they are poorly done in order to make them a success.

It is very likely we are in the second situation.

Victor Constancio, vice-president of the ECB, declared that not only the banking sector is now healthy and is not going to harm growth, but it is also able to resist another crisis in case it happens. Half of the bank that failed already raised enough capital to respect the threshold set by the ECB and the European Systemic Risk Board. According to the final report, the capital actually needed to make all banks "safe" is less than 10 billions euros.

But this analysis doesn't hold up to the reality. More specifically, the scenarios used for this stress test are way too optimistic compared to the actual risks the euro zone is facing.

Let's first compare the baseline scenario with the consensus:

![Comparison: Baseline scenario / economic consensus, INFLATION (%)](image1.png)

![Comparison: Baseline scenario / economic consensus, GROWTH (%)](image2.png)

Clearly the baseline scenario, supposed to reflect the actual economic environment, is out of date. Victor Constancio explained that this optimism was due to the fact that hypothesis were made in April. However first news about lower growth and inflation forecasts came out in may and june, and nothing explains why this hasn't been adapted since.

But the most shocking assumptions are made for the "crisis" scenario.

After the subprime and euro zone crisis, where the European taxpayers had to contribute to save banks, a truly healthy banking sector should be able to prepare and resist to a similar shock… unless the ECB clearly states that taxpayers should be ready to clean up the mess once again.
If we look at more specific shocks on different asset, we can observe for bonds that it is way lower than what we had during the euro crisis few years ago.

### Comparison of long term interest shocks: crisis scenario / euro crisis

<table>
<thead>
<tr>
<th></th>
<th>Crisis scenario (2014)</th>
<th>Euro crisis* 2010-2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Spain</td>
<td>+1,91 %</td>
<td>+2,93%</td>
</tr>
<tr>
<td>Greece</td>
<td>+3,16%</td>
<td>+16,12%</td>
</tr>
<tr>
<td>Ireland</td>
<td>+1,48%</td>
<td>+6,10%</td>
</tr>
<tr>
<td>Italy</td>
<td>+2,05%</td>
<td>+2,98%</td>
</tr>
<tr>
<td>Portugal</td>
<td>+2,31%</td>
<td>+7,28%</td>
</tr>
</tbody>
</table>

* october 2010 to october 2011

And the same for the stock market:

### Comparison of stock market shocks

In addition to very bullish scenarios, the methodology can be criticized.
Indeed, page 15 of the final report, we can read:

"The stress test was executed by the banks themselves, following a methodology designed and published by the EBA along with a baseline scenario [...] Therefore, although the ECB retained the final versions, the results were in all cases initially created by the bank."

Even if the ECB says that they checked the results, there is not way it was as precise and safe as if they had done them themselves. Moreover, the use of the risk-based capital ratio is quite ineffective. Indeed, since the study of two Bank of England Economist, Haldane and Madouros (2012), we know that only the leverage ratio is pertinent and statistically significant to assess banks’ solidity:

![Chart 4: Average solvency ratios of major global banks, end-2006](image)

![Chart 5: Leverage ratios of major global banks, end-2006](image)

Indeed, the risk-based capital ratio, even if computed by brilliant economists and mathematicians, always relied on assumptions that has been proved wrong in the last decade such as: states can't go bankrupt or house price can't plunge sharply.

To conclude, the ECB stated few days after the stress test that the size of European banks' bad loans accounted for about 4% of their assets... which means they are larger than their equity on average.

Other studies (like the one from the ZEW institute), have found that capital needed by eurozone banks is 20 times larger that what the ECB says...

This stress test looks more like a desperate attempt to increase confidence than a truly and effective supervision. The European banking sector looks more like a house of cards than a fortress.

All the views expressed are opinions of Bocconi Students Investment Club members and can in no way be associated with Bocconi University. All the financial recommendations offered are for educational purposes only. Bocconi Students Investment Club declines any responsibility for eventual losses you may incur implementing all or part of the ideas contained in this website. The Bocconi Students Investment Club is not authorised to give investment advice. Information, opinions and estimates contained in this report reflect a judgment at its original date of publication by Bocconi Students Investment Club and are subject to change without notice. The price, value of and income from any of the securities or financial instruments mentioned in this report can fall as
well as rise. Bocconi Students Investment Club does not receive compensation and has no business relationship with any mentioned company.