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Bittersweet Results Shared After European Central Bank Stress Tests

By Cho Rong Park, J.D. Candidate 2017 | November 11, 2014

The European stock market surged after stress tests revealed on October 26th that most European banks are healthy, where all but 13 of its leading banks have enough capital to survive another economic storm.

The results of the stress tests, announced by the European Central Bank ("ECB") and the European Banking Authority, identified that overall 25 out of 150 banks had technically failed the test, falling short of €24.6 billion. Most of these banks have already started to remedy their situations, leaving 13 banks to come up with extra capital of €9.5 billion ($12 billion).

Stress tests are utilized by bank regulators to determine if banks can survive financial crises. The tests focus on capital ratios that measure the proportion a bank sources through its own cash flows compared to shareholder funds. The current ECB test results came about half a decade after the United States imposed similar tests on its banks.

These results focused attention on the bittersweet condition of some European countries, mainly Italy and Greece, both from the PIIGS (Portugal, Italy, Ireland, Greece and Spain) group. Italy faces disgrace being the country with the highest number of banks that failed, whereas Greece is assessed to have acquired a rather healthy capital.

From the original 25 banks that had failed, 9 out of 15 were Italian banks (60%) and 3 out of 4 were Greek. Although the relative failure percentage for Greece is high, the country is satisfied because despite its CET1 (Common Equity Tier 1) ratio that caused the failure, their capital standards were met. Four Greek banks have acquired additional capital during the beginning of this year. On the other hand, the world's oldest bank, Banca Monte de Paschi di Siena SpA of Italy, fell short of €2.11 billion in capital under the test.

Overall, banks in Spain and Germany, which have been a focal point for investors, aced the tests with only one small bank in each country that had failed. France also had an "excellent" showing, according to Christian Noyer, governor of France's central bank.

"This unprecedented in-depth review of the largest banks' positions will boost public confidence in the banking sector," said ECB Vice President Vítor Constâncio. "This should facilitate more lending in Europe, which will help economic growth."

However, although the bittersweet results are split amongst the continent, some experts still share the view that these results are unlikely to quell future doubts on the banks' capability to survive long-term.

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"The situation we have of banks without sustainable long-term business models still exists," said Martin Hellmich, a professor at the Frankfurt School of Finance and Management. "There are still serious problems in the banking sector."

Likewise, there is a view that if the standards in this test were quite easy, it would become another setback for both the European economy as well as the ECB. "On the whole it seems to me that the E.C.B. has passed its own stress test today," Nicolas Véron, a senior fellow at Bruegel, a research organization in Brussels, said by email. "This exercise appears credible as of now."