Discussion on the Outlook in Europe

European policymakers have embarked on an ambitious set of reforms aimed at creating a European banking union. This process began 18 months ago and when completed will be the largest consolidation of power at the European level since the creation of the single currency. The plan will see the European Central Bank assume supervisory responsibilities for Europe's banks. The intent is to break the link between the financial stability of Europe's countries and their banks; however it is not clear that this will be accomplished.

European Central Bank becomes regulator for Europe's banks

The European Central Bank (ECB) formerly had no supervisory authority, and focused solely on monetary policy. However, it will become the primary regulator for Europe's banks in 2016, superseding a network of national regulators with varying sets of rules. As such, the ECB will become both the regulator for and resolution authority of the largest European banks. Since the ECB has never had oversight powers, it is currently building a supervisory team, hiring nearly 800 supervisors as well as support staff. This group will be headed by Danièle Nouy, secretary-general of France's Prudential Supervision and Resolution Authority.

Although a single system under law, the ECB will only directly supervise 130 of Europe's 6,200 lenders. These institutions, however, comprise 85 percent of Europe's banking assets. The resolution authority granted will cover an additional group of banks, as well as any cross-border institutions.

Bank failures will be handled by a single resolution board made up of national authorities as well as independent appointees. The board will prepare recommendations on banks that should be failed as well as prepare recommendations on how to wind up or rescue a bank. Cases would initially be handled by a smaller executive board.

Inexpensive failures will be relatively straightforward; however, more expensive ones will require significant agreement. A larger failure will require two thirds of the board to agree, as well as the approval of any countries contributing the majority of the common fund.

Stress Test

Before assuming regulatory responsibilities for Europe's banks, the ECB is creating and administrating a stress test to establish the condition of the banks it will supervise. This stress test will be a delicate process as the ECB looks to establish its credibility without undermining confidence in the banking system. The goal is to conduct a strict, credible stress test that will highlight any capital shortfalls and—when the short falls are addressed—inspire confidence in the system. Given the number of banks involved and the reluctance of national bodies to recapitalize banks, this is not a straightforward task.

Previous stress tests on Europe's banks—conducted by the European Banking Authority—were relatively lax, and thus lacked credibility. The ECB has emerged from Europe's crisis as one of the remaining institutions with its credibility intact. It must ensure the tests are strict enough to maintain this credibility.

The ECB recently announced that it has lowered the minimum capital ratio that banks must be able to maintain under a stressed scenario to 6 percent, down from 8 percent.

The stress test will be designed to establish the risks in the banking system, as well as analyze asset quality. There is concern that banks in some regions may not yet have fully realized and written down loans that have gone bad. The test will stress banks' assets against a number of potential shocks. In particular, the ECB is likely to stress holdings of sovereign debt. Following the ECBs Long Term Refinancing Operation, which injected nearly $1 trillion into European banks, many European banks invested heavily in sovereign bonds.

Once a credible stress test has been run, the next challenge will be to address any capital shortfalls that are exposed. Unlike the U.S. stress tests in 2009, where there was political will to fill any capital shortfall, there are limited existing funds and little political will to recapitalize Europe's banks. An independent review of Spain's banks conducted by Oliver Wyman revealed a $76 billion capital shortfall in Spain alone.

Resolution Fund

A resolution fund will also be put into place to cover the cost of any bank failures. Shareholders and creditors will take the first losses due to new bail-in requirements set by the European Union (EU), after this the resolution fund will cover losses. The fund is set to be €55 billion, and is slated to be fully capitalized by 2026.

Until the fund is fully capitalized it will be split into national funds that are to be gradually merged. One concern is that the fund has no public backstop, so additional resources will not be available, even as the fund is beginning to become capitalized. As a result, for the time being, a bank's sovereign remains responsible.

An additional concern of many is that the size of the fund will be inadequate even when fully capitalized, as €473 billion in capital has already been injected into EU banks since 2008.