Box 4

AN ASSESSMENT OF THE CAPITAL SHORTFALL REVEALED IN THE EU-WIDE STRESS-TESTING EXERCISE

The European Union has recently completed an EU-wide macro stress test, in which 91 banks participated. The results were published by the Committee of European Banking Supervisors (CEBS) on 23 July, together with a press release issued jointly with the ECB and the European Commission.[1] In the exercise, a 6% Tier 1 capital ratio was set as the threshold for assessing the magnitude of capital shortfalls of the participating banks. It is important to note that this 6% ratio is not a regulatory minimum capital requirement. Under the adverse macroeconomic scenario applied in the test, seven banks published Tier 1 capital ratios below the 6% threshold, 20 banks had Tier 1 ratios of between 6% and 7%, and 13 banks had Tier 1 ratios of between 7% and 8%. The other 51 banks had higher capital ratios, demonstrating the overall resilience of the

1 The press release is available at http://www.ecb.int/press/pr/date/2010/html/pr100723_1.en.html.

EU banking system to a relatively severe adverse scenario. The aggregate capital shortfall of the banks that participated in the exercise was €3.5 billion, a figure which was somewhat lower than market participants had expected. This box sets this estimated capital shortfall in the context of the measures to bolster capital that had already been implemented prior to the stress test.

In assessing the size of the capital shortfall revealed by the EU-wide stress test, it must be borne in mind that this exercise was carried out at a rather late stage in the financial crisis, after a considerable amount of capital support had already been provided by EU governments to their banking systems. For instance, by end-2009, the starting point for the exercise, the EU banking sector had benefited from public capital support amounting to €222 billion (see the table). In addition, although the stress test took as a starting point the capital levels that prevailed at end-2009, in the estimation of the final capital shortfall figures the banks that participated in the exercise were allowed to count capital injections and increases that took place between end-2009 and 1 July 2010 as part of their Tier 1 capital. For the EU as a whole, such capital adjustments amounted to €14.8 billion. Of this total, €11.3 billion prevented banks from falling below the 6% Tier 1 capital ratio threshold (i.e. the amount of capital injected exceeded the amount needed to maintain the 6% Tier 1 capital ratio threshold by €3.5 billion). These capital adjustments included (i) capital injections by the Spanish Fund for Orderly Bank Restructuring (Fondo de Reestructuración Ordenada Bancaria – FROB) into several savings banks; (ii) the capital relief provided by the Spanish deposit guarantee fund for Caja Castilla-La Mancha; and (iii) the capital increase by Bank of Ireland.[2]

The capital injected into some euro area banking systems between end-2009 and 1 July 2010 had the effect of lowering the aggregate capital shortfall revealed by the EU-wide stress test under the adverse scenario. Taking full account of the measures to bolster capital that were implemented during this period, it is possible to compute a "gross capital shortfall", i.e. the shortfall that would have prevailed had the banks that participated in the exercise not been allowed to include these additional measures in their calculations. In total, this gross capital shortfall would have amounted to €14.9 billion (which is the sum of €11.3 billion of additional capital measures that counted against a shortfall and the €3.5 billion "net capital shortfall" revealed by the stress test).[3]

2 The Bank of Ireland raised €1.7 billion from private investors. It also converted €1.7 billion of the government's €3.5 billion preference shares into ordinary equity. This conversion is, however, neutral for the capital shortfall computation and is therefore not included here.

3 The figures used in this calculation do not add up owing to rounding.

Capital measures and shortfalls in the EU stress test

(EUR billions)

	EU	Euro area	DE	ES	GR
A) Public capital injected before end-2009	222	146	54	12	3
B) Capital measures taken between end-2009 and 1 July 2010	14.8	14.8[1)]	0.0	13.1[2)]	0.0
C) *Of which offset against the estimated capital shortfall*[3)]	*11.3*	*11.3*	*0.0*	*10.6*	*0.0*
D) Net capital shortfall identified in the stress test	3.5	3.5	1.2	2.0	0.2
E) Gross capital shortfall (C+D)	14.9	14.9	1.2	12.6	0.2
F) Remaining public commitment	189	147	11	88	12[4)]

Sources: CEBS, FROB and ECB calculations.
1) The amount reported includes the sum of capital measures taken in Spain and the €1.7 billion of capital that Bank of Ireland raised from private sources.
2) The amount reported includes (i) the €10.58 billion of capital injected into Spanish banks by the FROB and (ii) the €2.48 billion of capital relief provided by the Spanish deposit guarantee fund to Caja Castilla-La Mancha.
3) The amount includes the share of the capital measures that prevented a capital shortfall in the stress test, i.e. the share that brings the Tier 1 capital ratio to 6%.
Individual items may not add up to the total owing to rounding.
4) The amount reported includes (i) the remainder of the old recapitalisation scheme (€1.8 billion); and (ii) the new Financial Stability Fund (€10.0 billion), which is currently being implemented.

Any capital shortfall should be judged against the financial resources available. In this respect, it is important to bear in mind that the commitments made by EU governments to support their banking sectors provide ample funds to address even sizeable capital shortfalls. In particular, EU governments have pledged a further €189 billion (€147 billion of which has been pledged by euro area governments) that could be injected into banks if needed. Moreover, in all three countries where some banks "failed" the stress test, the remaining amounts pledged are sufficient to cover the capital shortfalls revealed by the exercise. For instance, in Germany, Spain and Greece, the pledged capital that remains after subtracting the sum already injected amounts to €11 billion, €88 billion and €12 billion respectively. Furthermore, the banks perceived to have failed the stress test and the respective national authorities have swiftly communicated their intentions to implement further recapitalisation measures.