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Asset Management

EU Bank Stress Test: Strong Results

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After last week's Friday close the European Banking Authority (EBA) published the results of its latest stress test on 50 large European banks from 15 nations, representing 70% of EU banking assets. According to the EBA, "Banks have continued building their capital base." In addition, "This was achieved despite an unprecedented decline of the EU's GDP and the first effects of the Covid-19 pandemic in 2020." The last European bank stress test was three years ago, and the banks are in better shape today.

These stress tests do not have pass/fail grades. Rather, they are important inputs into regulators' individual reviews of banks, including those banks' capital adequacy, and appropriate levels of common stock dividends, stock buybacks and staff bonuses. In aggregate, the 50 banks' common equity tier 1 (CET1 — a key capital measure) started at 15% (the highest level since the EBA began performing stress tests) in 2020, and fell 485bp at end-2023 under the EBA's tough, adverse 3-year scenario, resulting in CET1 capital above 10% -- still a healthy figure. The average bank leverage ratio (another important capital measure) fell from 5.6% to 4.3% — also above minimums. The EBA's adverse stress scenario envisions a prolonged Covid experience, and a 'lower for longer' interest rate environment. These factors drove loan losses up and net interest income down under the adverse scenario stress test, resulting in the fall in capital levels.

Earlier in July, the European Central Bank (ECB) announced that at the end of September it would lift the blanket restrictions it had imposed on banks' common stock dividends and buybacks at the beginning of the Covid pandemic. This supportive move reflects the ECB's stronger confidence in the economic recovery, and banks' overall strength.

Spectrum views these strong stress test results, and the ECB's dividend action, as positive indicators of European bank health, and their capacity to service their AT1 and other hybrid securities.

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