[Heard on the Street](http://online.wsj.com/public/search?article-doc-type=%7BHeard+on+the+Street%7D&HEADER_TEXT=heard+on+the+street&mod=flashline): Europe’s Good-Enough Bank Stress Tests

ECB Succeeds in Conducting Meaningful Test Without Sparking Panic

The European Central Bank managed to give eurozone banks meaningful stress tests without raising fresh doubts about the financial sector. *Bloomberg News*

By David Reilly And Helen Thomas, WSJ.com, Updated Oct. 26, 2014 6:53 p.m. ET

A Goldilocks result: That is what the European Central Bank’s bank stress tests seem to have produced.

The trick for the ECB was to make the tests difficult enough that markets see them, and by extension bank-balance sheets, as credible, without producing so dire a result that it raises fresh doubts about the financial sector.

**In that vein, the tests—**[**with 25 banks failing and 13 needing to raise an additional €10 billion ($12.65 billion) in capital**](http://online.wsj.com/articles/ecb-says-25-banks-fail-stress-tests-1414321240)**—were in line with expectations, or slightly more severe than forecast.** And the result, released Sunday, was buoyed by the fact banks felt compelled to take action in advance, strengthening balance sheets by about €200 billion, including raising about €50 billion in equity in 2014.

Of course, the tests and **accompanying asset-quality review** don’t sound the all-clear siren. Previous tests of European banks by other agencies were found lacking when firms quickly ran into trouble after passing. And the level of stress such tests include will always be open to debate. The latest, for example, didn’t include a scenario in which the eurozone experiences deflation, nor did they include possible big litigation losses.

That so **many European banks continue to trade below book value** also shows the level of mistrust that exists. Erasing that will take more than one set of tests, even if they are seen as credible, and will depend, too, on the eurozone economy reviving.

In that vein, the tests shouldn’t be seen as something that will ignite broader economic growth through a sudden renewal of lending. Rather, they should hopefully put banks in better position to expand credit if demand picks up.

The tests, to some extent, confirmed investors’ long-held suspicions: **Failures were concentrated in crisis-hit eurozone markets like Cyprus, Greece and Italy.**

The results were, however, a blow for the latter: Nine Italian banks failed the tests. Four of those banks must raise further capital on top of previous efforts. That several Italian lenders fared poorly under regulators’ basic stress scenario, not just the adverse one, raises more questions about the past rigor of Italian banking regulation and suggests serious restructuring is still required to restore the country’s fragmented banking system to health.

Among banks that failed and face the biggest capital shortfalls were [Monte dei Paschi di Siena](http://quotes.wsj.com/IT/BMPS) of Italy and Banco Comercial Português of Portugal.

Looking at failed banks is also only part of the picture. Alberto Gallo at RBS points out that **30 banks only narrowly passed the stress tests, with capital ratios above the required 5.5% under the adverse scenario but still shy of 8%.**

They included several German lenders and larger institutions such as [UniCredit](http://quotes.wsj.com/IT/UCG) and [Mediobanca](http://quotes.wsj.com/IT/MB) in Italy.

Another potential sore point: The **tests didn’t include use of a leverage-ratio constraint**, a broader-brush measure of balance-sheet strength the U.S. Federal Reserve now includes in its tests.

On that basis, there was some more reason for concern. In a note to its report, the **ECB said 17 banks would have been below a minimum 3% leverage ratio. Based on the 4% threshold used by the Fed for big U.S. banks, 36 European firms would have fallen short, although differing accounting approaches can skew the result.**

Still, the tests and the asset-quality review are **a first step toward the ECB instituting a more rigorous supervisory framework as it takes over as Europe’s single bank regulator**. In that sense, they had to be good enough, not perfect.

And, as a starting point, the tests produced positive results. Regulators now have a harmonized definition of what constitutes a nonperforming asset. That, officials said, led to an increase in nonperforming assets of about €136 billion, while the asset review required an increase in provisions of €43 billion, or about 12%. Collateral was also adjusted downward by €39 billion.

On the whole, investors are likely to take a bowl-half-full view of the tests. The bigger problem is that the European economy is still too cold for eating.

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