



Insight

What Europe Stress Tests Wont Do

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On Sunday, the NYT carried an excellent story on European debt and who holds the debt. To me, the best part was the review of the ECB's vice president Lucas Papademos.

One of the biggest problems with European financial institutions is their opaqueness and therefore the market is unable to discern their overall health. This leads to uncertainty and to counterparty risk where banks don't want to lend to each other.

Yes, this is exactly what happened in the summer of 2007 with Bear Stearns that led to Lehman in 2008. It also led to the US Stress Tests which assisted in clearing the air over the general health of the American banks.

“Lucas D. Papademos, vice president of the European Central Bank, which gets an indication of banks' health based on which ones draw heavily on its emergency credit lines, said at a news conference Monday that a small number of banks were “over reliant” on that funding.....But Mr. Papademos, who retired last Tuesday at the end of his term, wouldn't be more specific. He said European banks would undertake a vigorous round of stress tests by July.”

On Friday's “Closing Bell,” I said this is exactly what I was hoping they would do. The market funding pressures have been building from European sovereign CDS to bank CDS to overnight Euribor and US libor. This is going to be a way to address it, but the European regulators also will need to release the information and get the governments to agree to inject capital to those banks in need.

One more thing to keep in mind, the US stress tests was done between February and March of 2009. Through this period, the markets didn't wait to see how it was going to turn out. Investors sold the US financial sector hard and the S&P dropped to its lows. Why wait for the outcome? Sell everything and then buy back the banks that look the healthiest.

Keep this mind while we wait for the European stress tests to be done. Due to the fractional nature of the European Union and European Monetary Union, the coordination of the process won't be nearly as streamlined as the US.

There is a potential for a race to the bottom for the regulatory oversight and the desire to protect “local champions” during the review. Therefore, the potential outcome won't be nearly as successful.

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