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A time for stress: The challenges facing Europe's banks

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In November the European Central Bank (ECB) will officially take overall responsibility for the supervision of major European banks under the Single Supervisory Mechanism. This is one of the biggest structural changes in the financial-services regulatory environment in the past 30 years. Europe's banks are facing tough new minimum standards. As they respond they are realizing that they need to make some major changes.

The centralization of regulatory responsibility has already effectively begun, with the ECB acting as the primary driver of a "comprehensive assessment" on 128 European banks. The assessment, which consists of an asset-quality review and a stress test, will be released in October. Countries and the banks within them will be told how they have measured up and whether further changes are needed to increase their resilience.

This complex new regulatory reality is proving quite challenging for many of the institutions involved, as it calls for an unprecedented effort with respect to logistics, depth and breadth of data and information requested, and the sheer amount of documentation required. In addition, the review extends to all areas of the banks, requiring entire organizations to be mobilized.

How should banks respond? A starting point is to acknowledge that they face regular scrutiny and testing in future. In particular, stress tests appear to have become a structural feature of regulation rather than occasional one-off events. Experience in America suggests that the ability to fulfill stress-testing requirements under time pressure will be a necessary condition for a banking licence.

Given that, we think there are six areas where banks will have to focus their efforts. The first is governance, specifically the need to become much more centralized in their monitoring and compliance. The authority and resources of central units will need to grow, and local management will need to adapt to a new world where using the argument of "local regulatory requirements" will no longer suffice. Banks will need to ensure a coordinated interaction with the ECB, avoiding potentially dangerous duplications of contact points or communication channels.

The second area concerns data and IT infrastructure. Most European banks are likely to find that producing the information the ECB will require will be an enormous challenge. Assuming the United States as a proxy, the ECB is likely to require an enormous amount of detail, but will demand at the same time summarized formats that make it easier for it to quickly analyze the overall picture and decide which areas need further scrutiny. For the current stress test, for example, the ECB allows banks just two months to complete a methodology that includes 36 Excel templates covering all types of risks (i.e., approximately 60,000 cells).

Having a robust data and IT infrastructure is a pre-requisite to deliver the information at the level of detail required. Quality, integrity, and consistency of data on clients, portfolios, and collateral are critical for success.

Additionally, banks will need to retrieve and homogenize historical data series on their risk measures, including proxies for periods and portfolios not covered by internal sources.

The third area relates broadly to banks' internal processes. Banks are likely to find that getting to "the right numbers" is necessary but not sufficient. Assuming again that the United States is a proxy, the ECB is likely to put a lot more emphasis on the "quality" of the processes used by a bank to develop its numbers. This creates an urgent need for banks to be able to show evidence of effective centralized structures that demonstrate steering and control on all relevant risks at a portfolio level. Banks will need to restructure key processes that define, control, and monitor credit and risk policies across different regions and legal entities.

Fourth, banks face a significant challenge in how they model their main risks and how they integrate currently disparate systems. Many banks are likely to be caught off guard by the sheer number of models ECB regulators think is necessary to accurately model a bank under a severe adverse scenario. One overall model for a given portfolio (for example, domestic mortgages) may need to mushroom into five or ten individual models based on geography, credit quality of the customer, and type of collateral.

Fifth, bank managers will need to build their capabilities for understanding and interpreting model results to ensure that bottom-up stress-test outputs make sense and fit within an integrative narrative that makes an outside party comfortable that the bank's executives have taken the exercise seriously and given it their best effort, being immersed at an appropriate level of detail while still seeing the big picture. Regulators will want to see evidence that the bank's senior executives, and the board, at least debated making changes to the bank's strategy and key operating practices after considering the results from the stress-testing exercise.

Finally, banks should have clear and comprehensive documentation for all aspects of their processes, including their risk-measurement and risk-management infrastructure, loss and capital shortfall estimation methodologies, the process for making decisions, and the efficacy of control and governance functions. That might seem a banal challenge, but it is probable that many banks are likely to underestimate the quantity and quality of documents that the ECB overseers will require. On their exercises, US banks have typically submitted more than 2,000 pages, split into as many as 65 documentation modules detailing results, methodology, and governance.

This adds up to a serious set of challenges for the management teams of Europe's leading banks. None of the areas we have identified can be considered voluntary or inconsequential. In fact, they interrelate to the extent that banks are in effect remaking themselves in fundamental ways, with no certainty as to the end point. Their stress might last a long time yet.

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