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2018 EU-wide stress test: Frequently Asked Questions

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Scope and process

1. What is the objective of the EU-wide stress test?

The EU-wide stress test is part of the supervisory toolkit used by Competent Authorities (CAs) to assess banks' resilience to adverse shocks, identify residual areas of uncertainties, as well as feed into the supervisory decision-making process to determine appropriate mitigation actions. Moreover, the exercise aims to strengthen market discipline through the publication of consistent and granular data on a bank-by-bank level.

2. Which banks are involved in the exercise?

The EU-wide stress test is conducted at the highest level of consolidation in the EU (group level) and covers a sample of 48 banks – 33 from countries in the euro area and the rest from Denmark, Hungary, Norway, Poland, Sweden and the UK – representing about 70% of EU banks' total assets.

3. Why are banks of some EU countries not included in the exercise?

There are several reasons. Since the exercise is performed at the highest level of consolidation, subsidiaries of a parent bank already in the sample are not included. In addition, the euro area is considered as a single jurisdiction, which implies that relatively smaller banks in some euro area countries are not included but are still subject to the stress test run by the ECB-Banking Supervision. Further to this, Greek banks had to publish their stress test results in May, as their publication timeline was accelerated to ensure the results were ready before the end of the third European Stability Mechanism (ESM) Programme for Greece.

4. What is the role of the EBA?

The EBA is responsible for developing a common methodology and coordinating the exercise. The EBA also supports the quality assurance process by providing minimum guidance and EU-wide descriptive statistics on the main risk parameters, which enable CAs to perform consistency checks and to undertake a rigorous assessment of banks' results. More importantly, the EBA acts as a data hub for the final dissemination of the outcome of the exercise, thus ensuring transparent and

comparable disclosure of banks' results. Finally, the EBA plays a key role in ensuring effective communication and coordination between home and host authorities in the framework of colleges of supervisors.

5. What are the roles of other ECB, ESRB, the national CAs and the ECB-Banking Supervision?

The ESRB and the ECB, in close cooperation with CAs, the EBA and national central banks, are responsible for designing the adverse macroeconomic scenario. The ECB also provides the macroeconomic baseline scenario. CAs, including the ECB-Banking Supervision for the euro area banks, are responsible for the quality assurance process ensuring that banks correctly apply the common methodology developed by the EBA. In particular, CAs and the ECB-Banking Supervision are responsible for assessing the reliability and robustness of banks' assumptions, data, estimates and results. Furthermore, CAs are also responsible for any resulting supervisory actions.

Methodology and scenarios

6. What are the key methodological features of the 2018 EU-wide stress test exercise?

The EU-wide exercise is a solvency stress test based on a constrained bottom-up approach. This means that banks apply the common methodology developed by the EBA using their own models. However, banks' projections are subject to constraints and to a static balance sheet assumption, meaning that their balance sheet is frozen at the reference date and that possible managerial actions for mitigating the impact of the shocks are not taken into account. This ensures consistency and comparability of the projections. Compared with the previous stress tests, the main new features are the implementation of IFRS9 and a single scenario for market risk, which includes a specific treatment for Level 2 and Level 3 financial instruments.

7. Which risks are covered in the exercise?

The 2018 EU-wide stress test exercise is focused on the assessment of the impact of risk drivers on the banks' solvency. Banks are required to stress test the following common set of risks:

- Credit risk, including securitisations;
- Market risk, counterparty credit risk (CCR) and credit valuation adjustment (CVA);
- Operational risk, including conduct risk.

Risks arising from sovereign exposures are covered in credit and in market risk, depending on their accounting treatment. In addition to the risks listed above, banks are also requested to project the effect of the scenarios on net interest income and to stress profit & loss items not covered by other risk types.

8. How is sovereign risk treated in the stress test methodology?

The risks arising from sovereign exposures are covered in credit risk and in market risk, depending on their accounting treatment. For sovereign exposures measured at amortised cost, banks had to

estimate default and impairment flows applying a set of probabilities of default (PD) and loss given default (LGD) parameters developed by the ECB for a selection of countries. Sovereign exposures measured at fair value through profit or loss and fair value through Other Comprehensive Income are treated under the market risk methodology by applying a full revaluation performed under the adverse market conditions described in the market risk scenario.

9. How did EBA ensure consistency of the results across banks?

The exercise is conducted across the EU and its consistency relies on a rigorous assessment of banks' results as well as on the comparability of data. To this end, two elements are crucial: (1) common baseline and adverse macro-economic scenarios; and (2) a common methodology and consistently applied constraints, such as a static balance sheet. In addition to this, during the quality assurance process run by CAs, the EBA also provided them with comparative analysis of the results (EU-wide descriptive statistics) to support their quality assurance of the results. Full disclosure of the results and banks' exposures provides market participants with the tools to compare and contrast EU banks under baseline and adverse market conditions. Lastly, as a follow-up action, banks' results are discussed in the framework of colleges of supervisors involving home and host authorities, as well as the EBA.

10. How is the introduction of IFRS 9 impairment model reflected in the 2018 EU-wide stress test?

While the recognition of credit losses under IAS 39 is based on the identification of a credit loss event, known as 'incurred loss' model, IFRS 9 is a forward-looking model based on the recognition of expected credit losses (ECL). Exposures are classified as stage 1, stage 2 or stage 3 depending on their credit quality. Stage 1 exposures are those where credit risk has not increased significantly since origination and impairments are based on 12 month ECL. Exposures are moved to stage 2 if credit risk increases significantly, determining the need to recognise lifetime ECL. In stage 3, exposures are credit-impaired, at the point that under the IAS 39 an incurred loss is accounted. Even if with some adjustments, this logic is reflected in the stress test methodology, which implies that the adverse shock determines the migration of exposures across stages and the need for additional impairments, affecting banks' capital positions.

For the banks that apply IFRS 9 in the 2018 financial year, 2017 starting figures have been restated according to IFRS 9. The impact of the restatement, which is independent from the stress test, is provided in the aggregate report as well as in the transparency templates. This impact might differ from the restatement shown in banks financial statements (or IFRS 9 transition reports) since the stress test methodology includes some simplifications for consistency reasons. The impact of the stress test is measured as the difference between the restated CET1 ratio and the ratio in 2020 under the adverse scenario. Since the implementation of IFRS 9 is subject to transitional arrangements, both transitional and fully loaded ratios are provided. While the latter are more comparable, the former are the relevant requirements and metrics for supervisory measures.

11. Does the stress test exercise take into account issues like anti-money laundering? How do these reflect in the stress test results?

Yes it does. The stress test methodology defines conduct risk as the current or prospective risk of losses for an institution arising from an inappropriate supply of financial services, including cases of willful or negligent misconduct. The definitions specifically mention that violation of national and international rules and regulations, including anti-money laundering (AML), should be treated as conduct risk event. Therefore, banks should include fines and costs connected to AML issues in their projections of either non-material or material conduct risk losses. These projections are quality assured by supervisors based on the qualitative and quantitative information that banks should provide.

12. What are the key features of the adverse scenario?

The most important shocks of the EU adverse scenario would lead to:

- Cumulative fall in GDP over 3 years by 2.7%;
- Unemployment reaches in 2020 9.7%;
- Cumulative inflation over 3 years stands at 1.7%;
- Cumulative fall in residential and commercial real estate prices over 3 years of 19.1% and 20% respectively.

13. How severe is the adverse scenario, compared to the previous exercises?

The adverse scenario of the 2018 EU-wide stress test is more severe than any previous EU-wide exercise. The scenario implies a deviation of EU GDP from its baseline level by 8.3% in 2020, an increase in the unemployment of about 3.3 percentage points by 2020, a fall of the inflation by 1.9% below the baseline and a fall of residential and commercial real estate prices by 27.7% and 27.1% respectively below the baseline level by 2020. In terms of GDP growth deviation from the baseline, the scenario falls between the adverse and severely adverse scenarios used in the Comprehensive Capital Analysis and Review exercise run by the Federal Reserve Board.

14. Does the adverse scenario cover all possible threats to banks?

No it does not. The adverse scenario is hypothetical and is not designed to capture every possible confluence of events. However, it does serve as an analytical tool to understand what could happen to banks' balance sheets if an economic downturn materialises. While the EU-wide stress test serves the purpose of assessing banks' resilience to a common range of adverse market developments, a single scenario cannot include all possible sources of risks and banks and supervisors should assess additional potential and in some cases very idiosyncratic weaknesses as part of the SREP.

15. Does the adverse scenario cater for Brexit?

The adverse scenario encompasses a wide range of macroeconomic risks that could be associated with Brexit. Further to this, elements of the baseline scenario already reflect the average of a range of possible outcomes from the United Kingdom's trading relationship with the European Union. Banks and supervisors should assess these potential and idiosyncratic weaknesses as part of the Brexit contingency planning (see also EBA June 2018 Opinion on Brexit preparedness – [EBA/Op/2018/05](#)) and the SREP.

16. Does the adverse scenario cater for recent market developments?

The adverse scenario reflects the four systemic risks identified by the ESRB General Board as representing the most material threats to the stability of the EU financial sector at the time when the scenario was developed. These include: (1) the abrupt and sizeable repricing of risk premia in global financial markets; (2) adverse feedback loop between weak bank profitability and low nominal growth, amid structural challenges in the EU banking sector; (3) public and private debt sustainability concerns amid a potential repricing of risk premia and increased political fragmentation; and (4) liquidity risks in the non-bank financial sector with potential spillovers to the broader financial system. The scenario remains, therefore, relevant also in light of the recent market developments.

Results

17. How do 2018 results compare to those released in 2016?

It is difficult and to some extent inaccurate to compare exercises across time, since the sample of banks, the starting capital ratios, scenarios and the methodological aspects change. Overall, however, the CET1 ratio depletion is higher in 2018 than in 2016 and the impact on the CET1 ratio due to credit risk losses, the main driver of the results, also larger.

18. How do IFRS 9 transitional arrangements affect the stress test results and their comparability?

Regulation (EU) 2017/2395 amended the Capital Requirements Regulation (CRR) to allow banks to include in its CET1 capital a portion of the increased expected credit losses under IFRS 9 for a transitional period of 5 years. This means, *ceteris paribus*, the transitional impact of the stress test on CET 1 ratios for those banks applying the transitional arrangements will be lower. For this reason, both transitional and fully loaded ratios are provided in the summary report as well as in the transparency templates. While the latter are more comparable, the former are the relevant requirements and the metrics for supervisory measures. The summary report also provides a list of banks that decided to use the transitional arrangements.

Disclosure

19. How are data and results published?

One of the most important features of the EU-wide stress test exercise is the disclosure of an extensive amount of comparable bank-by-bank actual and projected data, with the intention of promoting market discipline and identifying potential weaknesses on banks' exposures. The level of transparency is comparable to the previous exercise conducted in 2016. The EBA released individual results for banks participating in the exercise along with detailed balance sheets and exposure actual data as of end of 2017. In addition, the EBA has made available interactive tools as well as data files for further analytical use by market participants, and has published an aggregate report of the results. The transparency provided through such disclosure will enable market participants to determine how banks are dealing with remaining pockets of vulnerability.

20. Why are sovereign exposures not disclosed as in the previous exercises?

Contrary to the 2014 and 2016 exercises, the EBA does not disclose bank-by-bank sovereign exposures by country of the counterparty for the starting point due to a change in the methodology. This information will be, however, available in the 2018 EU-wide transparency exercise, which is published annually in December.

21. Will there be any disclosure of actual data for banks not included in the EU-wide stress test?

The publication of stress test results for banks not in the EBA sample is a decision for CAs. The EBA already announced that it will be conducting a transparency exercise in December 2018 on a wider sample of about 130 EU banks. The exercise provides the wider public with a consistent tool to access actual data on the EU banking system, and is an important component of the EBA's responsibility to monitor risks and vulnerabilities and foster market discipline. As in 2017, the data will cover capital positions, risk exposure amounts, detailed sovereign exposures and asset quality. The data will be published for two reference rates, December 2017 and June 2018. The publication of the 2018 EU-wide transparency exercise will also be accompanied with the release of the annual EBA Risk Assessment Report.

Next steps

22. How will the stress test results feed into the SREP process and how will supervisors use these results?

The exercise does not include a defined pass/fail threshold. However, the 2018 EU-wide stress test is an important source of information for the purposes of the SREP and for setting Pillar 2 guidance. The results of the stress test will assist CAs in assessing banks' ability to meet applicable prudential requirements under the stress scenario. Furthermore, the results will form a solid ground for a discussion between supervisors and individual banks, in order to establish relevant management

actions so as to strengthen their capital planning and ensure that the banks will be above the applicable capital requirements under stress.

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