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2020 EU-wide stress test: Frequently Asked Questions

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## Key features of the 2020 EU-wide stress test exercise

### 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 relevant shocks, identify residual areas of uncertainties, as well as feed into the supervisory decision-making process to determine appropriate mitigation actions. Moreover, the exercise strengthens market discipline through the publication of consistent and granular data on a bank-by-bank level, which illustrate how balance sheets are affected by common shocks.

### 2. How does the stress test work in practice?

The EU-wide stress test is a bottom-up exercise. The EBA develops a common methodology, which is applied by all banks using their internal models. Methodological constraints in several areas limit banks' degrees of freedom and ensure a level playing field and comparability of the outcomes. Banks' results are checked and quality assured by Competent Authorities. The common methodology allows Competent Authorities to undertake a rigorous assessment of banks' resilience under stress in a common and comparable way.

### 3. What is the role of the EBA?

The EU-wide stress test is initiated and coordinated by the EBA and undertaken in cooperation with Competent Authorities (the Single Supervisory Mechanism (SSM) for the euro area banks), the European Central Bank (ECB) and the European Systemic Risk Board (ESRB). The EBA is responsible for coordinating the exercise and for developing a common methodology. The EBA supports the quality assurance process by providing common quality assurance guidelines and EU-wide descriptive statistics on the main risk parameters to enable Competent Authorities to perform consistency checks and to allow them to undertake a rigorous assessment of banks' results. In addition, 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.

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#### **4. What are the roles of other ECB, ESRB, the national Competent Authorities and the Single Supervisory Mechanism?**

The ESRB, in close cooperation with the ECB, Competent Authorities, the EBA and national central banks, are responsible for designing the baseline and adverse macroeconomic scenarios. The baseline scenario is based on the forecasts of the ECB and National Central Banks, while the adverse scenario is developed by the ESRB's Task Force on Stress Testing and approved by the ESRB General Board.

Competent Authorities, including the Single Supervisory Mechanism for the euro area banks, are responsible for ensuring that banks correctly apply the common methodology developed by the EBA. In particular, Competent Authorities and the SSM are responsible for assessing the reliability and robustness of banks' assumptions, data, estimates and results. Furthermore, they are responsible for the quality assurance process as well as for determining the resulting supervisory actions.

#### **5. Which banks are involved in the exercise?**

The 2020 exercise covers a sample of 51 banks - 35 from SSM countries - representing about 70% of EU banks' total assets. UK banks will be included in the sample as the 2020 EU-wide stress test takes place during the implementation period following the UK's withdrawal from the EU. The EU-wide stress test is conducted on the highest level of consolidation (group level).

#### **6. What is the timeline for the stress test?**

After the launch of the exercise, banks will proceed to estimate the impact of the adverse scenario on banks' balance sheets. Banks will provide several submissions of stress test results to Competent Authorities and the EBA. These submissions are quality assured and challenged by the Competent Authorities. The EBA expects to publish the results of the exercise by 31 July 2020.

## **Key Methodological Features**

#### **7. What are the key features for the 2020 EU-wide stress test exercise?**

The exercise will be similar to the one conducted in 2018 and will be based on a bottom-up projection from banks subject to constraints and a static balance sheet approach. It will not include a defined pass/fail threshold. Competent Authorities will use the results of the exercise in the Supervisory Review and Evaluation Process (SREP).

The main changes compared to the 2018 methodology involve the net interest income (NII). The treatment of sight deposits – which was complex in the previous exercise – has been simplified and harmonised. In addition, the quantification of the average point of maturity for assets and liabilities – which in 2018 was based on banks' internal estimations but required significant quality assurance efforts – has been standardised.

With the introduction of IFRS 9 in the 2018 exercise, the credit risk methodology stayed relatively stable, except for the implementation of new regulation – namely, the NPL calendar and the new securitisation framework – and some minor enhancements relative to prior exercises. Further information has also been provided in the transparency templates on stages 1, 2 and 3 provisions under IFRS 9.

The main change in market risk is a revised definition of net trading income, standardising it for comparability and level-playing field reasons.

A significant improvement in the disclosure is that the transparency templates now provide information on Pillar 2 Requirements (P2R) for each bank at the start of the exercise.

The changes to the methodology result also in a reduction in data requirements, especially for credit risk templates, for which the input fields have decreased by roughly 30%.

#### **8. How will the EBA ensure consistency between both Eurozone and non-Eurozone countries in the conduct of the exercise?**

The exercise is conducted across the EU. Therefore, its consistency relies on the common methodology, same scenario, and a rigorous assessment of the granular transparency of results and underlying data. In addition, the EBA will provide comparative analysis at the end of the quality assurance process run by Competent Authorities. The bank results will also be discussed in the framework of colleges of supervisors involving home and host authorities, as well as the EBA.

## **Stress Test Scenarios**

#### **9. How is this year's scenario different compared to the previous exercises?**

Similar to the previous exercises, the narrative of the adverse scenario for the EU-wide banking stress test reflects the main risks for EU banks that have been identified by the EBA and the ESRB. For the first time, the adverse scenario considers a prolonged period of time of low interest rates (lower for longer). Therefore, the narrative depicts a scenario related to a prolonged period of historically low interest rates coupled with a strong drop in confidence leading to a significant weakening of economic growth in EU countries. This is in turn amplified by trade and geo-political tensions at the global level, coupled with additional stress in several emerging economies. In terms of narrative, the scenario is, therefore, very different compared to previous exercises, where the main driver was a repricing of global risk *premia*.

#### **10. How severe is the adverse scenario, compared to the previous exercises?**

The 2020 adverse scenario is more severe than in previous EU-wide stress tests. The severity of the scenario reflects a stage of the financial cycle where risks have built-up (which usually leads to stronger downturns) as well as the fact that more extreme tail-events have been considered.

The design of the scenario has also taken into consideration some of the proposals made in a recent report by the European Court of Auditors. In particular, the 2020 stress test scenario is based on a more explicit link between the scenario design and the systemic risk assessments of the ESRB, the ECB and the EBA.

In terms of real GDP growth, the scenario is more severe than all previous EU-wide stress tests. In addition, the cross-country dispersion of shocks has declined.

In terms of the maximum decline of real GDP from the starting point, the severity is higher than the one of the Bank of England (BoE) 2019 Annual Cyclical Scenario (ACS). The severity of the EBA stress test scenario falls between the adverse and severely adverse scenarios of the Federal Reserve's 2019 Comprehensive Capital Analysis and Review.

### **11. What are the key features of the adverse scenario?**

The banks have to apply the adverse scenario defined as a combined result of, inter alia, foreign demand shocks, financial shocks and domestic demand shocks in the EU. The most important shocks of the adverse scenario would lead to:

- a decline in EU real GDP by 4.3% from 2019 to 2022, due to a long-lasting recession;
- an increase in the EU unemployment rate of 3.5 percentage points within the same period;
- a fall in the Harmonised Index of Consumer Prices (HICP) in the EU, with the adverse level being 3.8% lower than the baseline level in 2022;
- a decrease in residential property prices by 24% below the baseline level by 2022, which corresponds to a cumulative fall in residential property prices over the scenario horizon by about 16.4% at the EU aggregate level.

The set of information provided in the scenario has also been enlarged in terms of completeness to reduce discretion on the use of data for projections.

### **12. Does the adverse scenario cater for Brexit?**

The adverse scenario encompasses a wide range of macroeconomic risks that could be associated with Brexit. 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.

### **13. Is climate change risk considered in the scenario?**

Climate change risk is not considered in the scenario, since it tends to have an impact over a longer time horizon than the three years used for the EU-wide stress test. The EBA would, however, carry out sensitivity analyses on banks' exposures to climate risk as part of its wider mandate to assess risks and vulnerabilities in the EU banking sector.

## Disclosure

### **14. How will data and results be published?**

The credibility of the EU-wide stress test rests on transparency and one of the most important aspects of this exercise is the disclosure of a large amount of comparable and consistent data across the EU. The level of transparency will be comparable to the previous exercise conducted in 2016. The EBA will release bank-level data, aggregate reports and interactive tools. The transparency provided through such disclosure will enable market participants to determine how banks are dealing with remaining pockets of vulnerability.

## Next steps

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

The 2020 EU-wide stress test will be a crucial piece of information in the SREP in 2020. The results of the stress test will allow Competent Authorities to assess banks' ability to meet applicable minimum and additional own funds requirements under the stress conditions against the common scenarios and assumptions. Furthermore, the results will form a solid ground for a discussion with supervisors and individual banks, in order to understand relevant management actions, such as how their capital planning may be affected by the stress and, therefore, ensure that the banks will remain above the applicable capital and liquidity requirements.

### **16. What is the connection between the 2020 EU-wide stress test and the discussion paper on the future changes to the EU-wide stress test?**

In parallel to the 2020 EU-wide stress test, the EBA has launched a consultation on the discussion paper on the future changes to the EU-wide stress test. This consultation is the first formal step in assessing possible changes to the EU-wide stress testing framework, which will be followed by an assessment of the potential options. The aim is to introduce potential changes for the 2022 EU-wide stress test. As such, that the current exercise will not be affected. All information on the proposal is available on the [EBA website](#). In the same link, interested parties are invited to submit comments to the proposal. The consultation runs until 30 April 2020.