2021 EU-wide stress test: Frequently Asked Questions

2021 EU-wide stress test: Frequently Asked Questions

Key features of the 2021 EU-wide stress test exercise

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

The EBA is mandated to assess risks and vulnerabilities in the EU banking sector, in particular through regular risk assessment reports and pan-European stress tests.

The stress test allows to assess if banks' capital generation over a certain time horizon is sufficient to cover possible losses and to support the economy in normal and in stressed times. It fosters market discipline through the publication of comparable, consistent and granular data on a bank-by-bank level, as it sheds light on how the individual EU banks' balance sheets might react under baseline and stressed economic and market conditions.

The EBA EU-wide stress tests are part of the supervisory toolkit used by EU Competent Authorities (CAs) to assess the resilience of EU banks, identify residual areas of uncertainties. Their results feed into the supervisory decision-making process to determine appropriate mitigation actions and, as such, are an input to the Supervisory Review and Evaluation Process (SREP). As spelled out in the EBA Guidelines on SREP, supervisors are expected to consider the impact of the stress test on the bank's situation, together with the possible managerial decisions and capital actions available or put forward by the bank to mitigate the impact of the stress, to understand their resilience and capital position, and assess the potential need to set a Pillar 2 capital guidance ("P2G").

2. Which banks are involved in the exercise?

The 2021 exercise covers a sample of 50 banks - 38 from SSM countries - representing about 70% of EU banks' total assets. In comparison with previous EU-wide stress tests, UK banks are no longer in the sample following the UK's withdrawal from the EU. The EBA EU-wide stress test is conducted at the highest level of consolidation (group level).

3. How does the stress test work in practice?

The EBA EU-wide stress test is a "bottom-up" exercise. This means that the EBA develops a common methodology, which is implemented by all banks under a baseline and an adverse macroeconomic and market scenario, with the close scrutiny of their respective supervisors and the EBA. 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 CAs. The common methodology allows CAs to undertake a rigorous assessment of banks' resilience under stress in a common and comparable way.

4. What is the role of the EBA?

The EU-wide stress test is initiated and coordinated by the EBA and undertaken in cooperation with CAs (including 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 CAs 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 throughout the exercise in the framework of colleges of supervisors.

5. What are the roles of other institutions, such as the ECB, the ESRB, the national CAs and the SSM?

The ESRB, in close cooperation with the ECB, CAs, the EBA and national central banks, are responsible for designing both the baseline and adverse macroeconomic scenarios which are then endorsed by the EBA's Board of Supervisors. The baseline scenario for EU countries is based on the December 2020 projections from the national central banks[1], while the adverse scenario is developed by the ESRB's Task Force on Stress Testing and approved by the ESRB General Board.

CAs, including the SSM, are responsible for ensuring that banks correctly apply the common methodology developed by the EBA. In particular, CAs and the SSM are responsible for assessing the reliability and robustness of banks' assumptions, data, estimates and results. Furthermore, they are responsible for determining the resulting supervisory actions.

Key Methodological Features

6. How are risks assessed in the 2021 EU-wide stress test exercise? And which risks are covered?

The EBA's EU-wide stress test is a constrained bottom-up exercise: banks provide the data and implement the EBA's methodology in the baseline and an adverse macro-economic scenario,

[1] For non-EU countries, the baseline is based mainly on the projections from the October 2020 IMF World Economic Outlook and on the projections of ECB staff based on October 2020 data from the OECD.

project the results, under the assumption of a static balance sheet[2] and taking into account the definitions, constraints, caps and floors defined in the methodology. This is necessary to ensure a minimum degree of conservatism, consistency and comparability of the projections and a level playing field. In addition, CAs (with support from the EBA) carry out an extensive quality assurance process to ensure the reliability and robustness of the results.

The analysis covers the impact on the banks' CET1 capital ratios of credit risk, market risk and operational risk[3] losses over the three years of the scenario. Additional drivers examined are net interest income and non-interest income and expenses items (e.g. Net Fees and Commissions Income, dividend income, share of the profit or loss of investments in subsidiaries, joint ventures and associates).

In the 2021 EBA EU-wide stress test, transparency templates provide information on Pillar 2 Requirements (P2R) for each bank at the starting point.

7. Which are the new methodological features of the 2021 EU-wide stress test exercise compared to the previous exercises?

After the 2018 EU-wide stress test, some improvements were introduced in the methodology in various areas. In particular, the treatment of sight deposits – which was complex in the 2018 exercise – was simplified and harmonised. In the area of credit risk, new regulation was implemented, namely, - the minimum loss coverage for non-performing exposures ("NPL calendar") and the new securitisation framework – and further disclosures on the breakdown of exposures by IFRS 9 stages were introduced. Information on Pillar 2 Requirements (P2R) for each bank at the start of the exercise was also included in the transparency templates.

The current exercise was initially supposed to be launched in January 2020. However, due the COVID-19 pandemic and its global spread, in March 2020 the EBA decided to postpone it to 2021, to allow banks to prioritise operational continuity and support to the economy. Instead, in 2020, the EBA published two transparency exercises, one in late Spring and one in late Autumn, to inform the public on the conditions of the EU banking sector at the start of the COVID-19 pandemic and on the impact of the crisis in the first half of 2020. In addition, in May 2020, the EBA published a Thematic Note (EBA Rep/2020/17) analysing the preliminary effects of COVID-19 pandemic on the EU banking sector, including a sensitivity analysis on parts of banks' credit and market risk portfolios.

The methodology has remained broadly similar to the one developed for the postponed 2020 stress test exercise, with a few improvements.

The support measures deployed in response to the COVID-19 pandemic have required additional changes to the methodology. In particular, the treatment of COVID-19 EBA-compliant moratoria

[2] The static balance sheet assumption requires that assets and liabilities that mature within the time horizon of the exercise are replaced with similar financial instruments as at the start of the exercise; no capital measures or managerial decisions completed after 31 December 2020 are considered.

[3] Operational risk losses include conduct risk losses and other operational losses.

and COVID-19 public sector guarantees were clarified More specifically, moratoria are not considered in banks' projections, and maturing loans guaranteed by COVID-19 public sector guarantees should be replaced with the guarantee for calculating the projections. In addition, information is also collected on exposures benefiting from COVID-19 moratoria and public guarantee schemes for public disclosure and to support quality assurance. Also connected to COVID-19 pandemic, the 2021 methodology reflects the amendments to the capital requirements regulation that were published in the Official Journal (the 'CRR Quick Fix') in June 2020. Finally, some specific changes have been introduced to recognise FX variations for certain P&L items.

8. Does the stress test exercise consider 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 a 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.

Stress Test Scenarios

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

Similarly to the previous exercises, the narrative of the adverse scenario for the EBA's EU-wide banking stress test reflects the main risks for EU banks that have been identified by the EBA and the ESRB. However, this time the narrative depicts an adverse scenario related to the ongoing concerns about the possible evolution of the COVID-19 pandemic. Such a downturn scenario is characterised by a strong drop in confidence leading to a prolongation of the worldwide economic contraction. These confidence shocks could be triggered by a mutation of the virus, significant setbacks in the distribution or acceptance of vaccines, possible further lockdowns following re-emerging waves of infections or other unexpected negative developments in the containment of the pandemic. The worsening of economic prospects is reflected in a global decline of long-term risk-free rates from an already historically low level and results in a sustained drop in GDP and an increase of unemployment. Slowing growth momentum would cause a drop in corporate earnings leading, together with a re-assessment of market participants' expectations, to an abrupt and sizeable adjustment of financial asset valuations as well as a significant drop in real estate prices (especially commercial). A decline in economic growth and rising risk *premia* could further challenge debt sustainability in the public and private sectors across the EU.

Finally, it's worth noting that the baseline scenario also takes into account exceptional circumstances, such as an unprecedented global macroeconomic shock which already affected the GDP numbers in 2020 with a gradual return to more normal conditions in subsequent years. In this respect, the baseline scenario also provides a useful yardstick to assess and compare the situation of EU banks assuming an orderly exit of the pandemic.

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

The adverse scenario is 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 lead to:

- a decline in EU real GDP by 3.6% from 2020 to 2023, due to a long-lasting recession;
- an increase in the EU unemployment rate of 4.7 percentage points within the same period;
- a falling Harmonised Index of Consumer Prices (HICP) in the EU, with the adverse level being 1.5% lower than the baseline level in 2023;
- a decrease in residential property prices by 21.9% below the baseline level by 2023, which corresponds to a cumulative fall in residential property prices over the scenario horizon by 16.1% at the EU aggregate level. The cumulative fall of commercial real estate prices from the starting point amounts to 31.2% for the EU due to a stronger impact of COVID-19 on the commercial real estate sector (home office and non-financial corporate insolvencies);
- an inversion of the EUR risk-free yield curve in the first year of the stress test horizon, which then becomes flat at negative level in year 2022 and 2023.
- an increase of long-term rates by 53 bps in aggregate EU terms at the three-year horizon, while the equities drop in the first year by 50% for Europe and the Developed World;

The convention used in the calibration of adverse scenarios for the 2021 EU-wide stress tests is one of “no policy change”. This means that neither monetary policy nor fiscal policy reactions are assumed under the adverse scenario over and above what is already embedded in the baseline scenario.

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

The 2021 adverse scenario is very severe having in mind the weaker macroeconomic starting point in 2020 as a result of the pandemic.

The design of the scenario has also taken into consideration some of the proposals made in the 2019 report by the European Court of Auditors. In particular, the 2021 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 (when measured as a change from the starting point), the scenario is comparable to previous EU-wide stress tests. The cross-country dispersion of shocks has declined compared to previous years. However, when measuring severity in terms of deviation from the baseline, the 2021 scenario is more severe than in previous exercises.

12. Is climate change risk considered in the scenario?

Climate risk is not explicitly considered in the scenario as methodologies to embed it in a stress test framework are still being developed. However, in 2020, the EBA carried out a pilot sensitivity analysis on a sample of volunteering banks from 10 jurisdictions covering 50% of the EU banking system total assets, in which EU corporate exposures are analysed in relation to climate risk. The results of the exercise were published on the EBA website and shed valuable light on the environmental sustainability of key portfolios of EU banks as well as on existing data gaps[4].

Results

13. How do the 2021 stress test results compare to those released in previous exercises?

Given the differences in the sample of banks, starting capital ratios and balance sheet structure, scenarios and methodology, comparing the results of the exercises across time is difficult and to certain extent even misleading.

Regarding the sample, the major change is the exclusion of UK banks. Concerning the scenario, this year's adverse macro-financial scenario is very severe as it follows an unprecedented shock in 2020 and assumes a prolongation of Covid-19 pandemic. It is also the first time that a lower-for-longer narrative is assumed, where accompanying worsening of economic prospects is reflected in a global decline in long-term risk-free rates from an already historically low level. This was not the case in the previous scenarios which, firstly, were not applied in the bottom of the economic cycle and, secondly, assumed increasing interest rates, due to the increase in risk premia.

However, if the capital impacts are compared, the CET1 ratio depletion in 2021 is overall higher than in 2018 and in 2016. While the impact on the CET1 ratio due to credit risk losses - the main driver of the results - is similar to the 2018 exercise, the projected net interest income is lower than in 2018. The latter is particularly impacted by the narrative of this year's adverse macro-financial scenario.

Disclosure

14. How are data and results published?

The credibility of the EBA's 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 EBA released individual results for banks participating in the exercise along with detailed balance sheets and exposure actual data as of end of 2020. 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.

[4] https://www.eba.europa.eu/sites/default/documents/files/document_library/Publications/Reports/2021/1001589/Mapping%20Climate%20Risk%20-%20Main%20findings%20from%20the%20EU-wide%20pilot%20exercise%20on%20climate%20risk.pdf

15. Why are sovereign exposures not disclosed?

As in the 2018 exercises, the EBA does not disclose bank-by-bank sovereign exposures by country of the counterparty for the starting point. This information will be, however, available in the EU-wide transparency exercise, which is published annually by the EBA at the end of the year.

16. 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 ECB-SSM will disclose, on 30 July at 19:00 CET, further information on other 51 SSM Significant Institutions (SSM banks) that were not included in the EU-wide stress test sample.

On a similar note, the EBA already announced that it will be conducting a transparency exercise in December 2021 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 2020, the data will cover capital positions, risk exposure amounts, detailed sovereign exposures and asset quality. The data will be published for four reference dates, September 2020, December 2020, March 2021 and June 2021. The publication of the 2021 EU-wide transparency exercise will also be accompanied with the release of the annual EBA Risk Assessment Report.

Next steps

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

The results of the stress test will allow CAs to assess banks' ability to meet applicable minimum and additional own funds requirements under the common downturn scenarios and assumptions. The results will form a solid ground for a discussion with supervisors and individual banks in the context of the normal supervisory cycle, in order to understand relevant management actions (i.e. banks' capital and distribution plans) and, therefore, ensure that banks will remain above the applicable capital requirements, while continuing to finance the economy. Due to the specific macroeconomic conditions caused by the Covid-19 pandemic, the results of the 2021 EBA's EU-wide stress test might also serve as valuable input to make informed decisions on possible exit strategies from the flexibility measures granted to banks due to the COVID-19 pandemic.

18. What is the connection between the 2021 EU-wide stress test and the work on the future changes to the EU-wide stress test?

In parallel to its 2021 EU-wide stress test, the EBA continued working to improve the current framework. The main focus is on further improving realism and efficiency, maximising the information value of the results, and investigating further the role of top-down elements in the EU-wide stress test approach. The mentioned criteria were prioritised after a discussion on the feedback received during the Discussion Paper on the future changes to the EU-wide stress test framework. The revision will focus on implementing a "hybrid" approach, whereby the constrained bottom-up approach could be complemented by top-down elements for some risk areas. As initially communicated at the end of July, a final decision on potential changes to the framework is expected to be taken later in 2021, with a view to implement those in the 2023 EU-wide stress test.