

15 July 2011

2011 EU-wide stress test: Technical background explanatory note to the EBA common Disclosure Templates

Introduction

1. Following the EBA methodology for the 2011 EU-wide stress test, the results of the stress test will be disclosed both on an aggregate and individual bank-by-bank basis. In addition to the overview of the results of the stress test under the baseline and adverse scenarios, institution-specific disclosures contain also additional information on participating banks' credit exposures and exposures to sovereigns.
2. The disclosure of institution-specific results and exposures are based on the pre-defined common disclosure Templates provided by the EBA. The structure and design of the templates are the same for all participating banks and neither banks nor supervisors have made changes to the Disclosure Templates unless explicitly agreed with the EBA. Any additional elements or clarifications deemed necessary by a bank, should be provided outside the Disclosure Templates by banks and/or their respective national supervisory authorities.
3. **The information presented in the Disclosure Templates is based on data supplied by each bank, via its respective national supervisor. Accuracy of this data is primarily the responsibility of the participating bank and national supervisor. This information has been provided to the EBA in accordance with Article 35 of EU Regulation 1093/2010. The EBA bears no responsibility for errors/discrepancies that may arise in the Disclosure Templates and/or underlying data.**
4. The Disclosure Templates are being published by all participating banks and re-published by national supervisory authorities on a country basis. The EBA is re-publishing on its website the disclosure templates for all 91 participating banks based on the consent from the national supervisor.

Structure of the disclosure templates

5. The institution-specific of the 2011 EU-wide stress test are disclosed on a bank-by-bank basis through six templates:
 - “0 – Summary” - high-level information on the overall results of the stress test under the adverse scenario, information on capital shortfall and high-level overview of planned mitigating measures.
 - “1 – Aggregate information” – detailed information on the results of the exercise for both years (2011-2012) under the baseline and adverse scenarios, including movements in losses, capital with and without the effects of mitigating measures, as well as cumulative impact of various mitigating measures. This worksheet also provides additional technical information on the evolution of provisions, coverage ratios and loss rates.
 - “2 – Capital composition” – detailed information on the composition of capital as of 31 December 2010 and elements included in Core Tier 1 capital according to the EBA definition used for the purposes of the stress test.
 - “3 – Mitigating measures” – detailed information on the mitigating measures a bank has put in place or plans to be put in place to mitigate the impacts of the stress test (e.g. additional mitigating measures not permitted by the exercise methodology, and hence not taken into account in the exercise, as well as all measures and including management business decisions taken or planned after April 2011).
 - “4 – EADs” – breakdown of an institution’s credit risk exposures by regulatory portfolios and geographies.
 - “5 – Sovereign exposures” – detailed breakdown of an institution’s exposures to central and local governments by countries/geographies, maturity and accounting portfolios.
6. All figures are reported in million EUR (or %) and published by the EBA also in EUR only. Banks normally reporting in other currencies, have made conversion of all figures into EUR using the ECB exchange rates as of 31 December 2010.

General principles underlying the disclosure of the results

7. Following the Methodology for the 2011 EU-wide stress test, the exercise has been carried out on the basis of a static balance sheet and stable business mix assumption. Some exemptions from this rule have been allowed in particular for mandatory restructuring plans agreed with the EU Commission or other legally binding agreements or plans publicly disclosed before 30 April 2011 and taking place within the time horizon of the exercise.¹

¹ See Section 4 of the Methodological note (http://www.eba.europa.eu/cebs/media/Publications/Other%20Publications/2011%20EU-wide%20stress%20test/EBA-ST-2011-004-%28Detailed-Methodological-Note%29_1.pdf)

8. As a general principle, the results of the stress test are presented with and without the effects of the mitigating measures permitted in the exercise (mandatory restructuring plans and capital raisings publicly announced and fully committed).
9. The rationale behind this approach is to allow a step-by-step understanding of the stress tests on the balance sheet of banks and particularly to illustrate clearly the impact of the numerous mitigating measures already put in place (e.g. mandatory restructuring plans and capital raisings) and that are planned for future.
10. This principle is most clearly demonstrated in worksheet "1 - Aggregate information" is structured as follows:

- The first block of figures (Section A) presents the outcomes of the stress test based on the full static balance sheet assumption without any effects of the exemptions from this assumption allowed by the exercise methodology (mitigating actions such as mandatory restructuring plans or capital raisings). All government support measures fully paid in before 31 December 2010 are incorporated. This information is provided to gauge the static situation and allow for better understanding of mitigating measures taken by institutions and national authorities/governments.
- The second block (Section B) focuses on the results of the stress test based on the static balance sheet assumption recognising capital issuances and mandatory restructuring plans publicly announced and fully committed before 31 December 2010 (e.g. restructuring plan agreed with the EU Commission before 31 December 2010 or Government commitment to pay in capital made before 31 December 2010). This would provide an overview of the results of the stress test, if done immediately on 1 January 2011.
- The third set of the results (Section C), captures the results recognising capital raised or fully committed and mandatory restructuring plans publicly announced and fully committed before 30 April 2011. This section sheds clear light on the steps taken to increase the resilience of the EU banking sector already in 2011. As this Section is the main focus of the results, additional details on evolution of profit and loss, as well as provisions, coverage ratios and loss rates are provided here.
- Finally the impacts of any other mitigating measures taken or planned by an institution (such as use of countercyclical provisions or divestments planned as a part of management strategy, etc.) are presented separately in the Section D. As opposed to mandatory restructuring plans permitted by the exercise methodology, management actions and other business decisions since December 2010 are presented in this section, as it is very difficult to distinguish "normal" business decisions taken as a part of business management from the specific decisions taken to mitigate the impacts of the stress. In this Section banks would show also the impacts of the future mandatory restructuring plans being discussed with the EU Commission and not finalised by 30 April 2011. All these measures are treated on the same grounds as back stop measures put in place by banks

and/or governments and agreed with national supervisors, as appropriate. The details of all additional mitigating measures presented in this Section should be elaborated in the worksheet "3 – Mitigating measures", and their impacts on the supervisory recognised capital ratio² would be shown in the worksheet "0 – Summary".

11. If under the national legislation, the release of countercyclical provisions and/or other similar reserves is allowed, this figure for 2010 could be included either in rows "Impairments on financial assets in the banking book" or "Other income" in the section on profit and loss information. Such release for 2011-2012 should be reported in Section D as other mitigating measures.
12. The high-level overview of the results of the stress test on the worksheet "0-Summary" focuses on the results of the exercise for 2012 under the adverse scenario clearly identifying the effects of mandatory restructuring plans fully committed before 30 April 2011, whilst any additional mitigating measures are shown "below the line".
13. **It should be clearly understood that the stress test has been carried out on the basis of the common EBA methodology, assumptions, and definitions. Hence, neither baseline scenario nor the adverse scenario and results of the stress test should in any way be construed as a bank's forecast or directly compared to bank's other published information.**

General principles underlying the disclosure of credit and sovereign exposures

14. In addition to disclosure of the results of 2011 EU-wide stress test, banks are disclosing their credit risk exposures and exposures to central and local governments (sovereign exposures). Such exposures are also based on the common methodology and definitions provided by the EBA and, therefore, cannot be directly compared to banks' own disclosures reported under Pillar 3, which can vary based on national regulation or market practices.

Credit risk exposures

15. In the worksheet "4 – EADs" banks have been requested to provide full overview of their credit exposures (exposure at default – EAD in the meaning of the CRD) as of 31 December 2010, which are used for the computation of risk weighted assets (RWA). All EADs are broken down by regulatory portfolios based on the EBA definitions for the purposes of this stress tests and, hence, not necessary matching national reporting practices. The exposures are also broken down by countries and macro areas. The

² The supervisory recognised capital ratio computed on the basis of additional mitigating measures presented in this section. The ratio is based primarily on the EBA definition, but may include other mitigating measures not recognised by the EBA methodology as having impacts in the Core Tier 1 capital, but which are considered by the national supervisory authorities as appropriate mitigating measures for the stressed conditions.

geographical breakdown should be provided for all exposure which, are equal or larger than 5% of total exposures. However, as some of the exposures might be difficult to map to particular geography, e.g. securitisation exposures, they may be reported in the "other" category.

16. With respect to breakdown of exposures by portfolios, it should be noted that not all portfolios are presented in the table and, therefore, the column "Total exposures" does not represent the sum of the components shown. "Total exposures", in addition to portfolios presented in the table, include EADs for securitisation transactions, counterparty credit risk, sovereigns, guaranteed by sovereigns, public sector entities, central banks, equities etc. The total column brings together all exposures used for computation of credit risk RWA also recognising the effects from funded credit risk mitigation and credit conversion factors, where applicable.
17. The EBA notes that despite all efforts to harmonise the reporting of the exposures in the Disclosure Templates, there might be some differences in approaches observed for some banks. In particular, there might be instances where banks have included exposure to public sector entities treated as institutions in the "Institutions" portfolio, whereas other may have included them only in "Total exposures" as they are treated as sovereigns, which are not reported separately in the table.
18. Another element of this table, where inconsistencies may arise is reporting of loan-to-value (LTV) ratios for commercial and residential real estate portfolios. The EBA recognises the lack of consistent definition and potential difficulties with providing this information according to the proposed structure and breakdown. Banks have been requested to provide this data on "best endeavour" basis and provide definition of LTV used in the footnotes to the table. Despite the potential inconsistencies of these ratios and possible lack of data for some geographies/banks, the EBA believes this is a very useful indicator of portfolio quality.

Sovereign exposures

19. The worksheet "5- Sovereign exposures" should be filled in for all direct and indirect exposures to all sovereigns (central and local governments). The definitions of sovereign exposures are explained in paragraphs 199 – 205 of the Methodological note³.
20. The worksheet "5 – Sovereign exposures" focuses on cash (e.g. debt securities) gross direct long exposures (immediate borrower basis approach) and derivatives towards sovereign and indirect sovereign exposures. Net direct positions represent the gross long positions of the banks held in the different books (trading, banking) net of cash short positions, ordinarily held in the trading book.

³ See: http://www.eba.europa.eu/cebs/media/Publications/Other%20Publications/2011%20EU-wide%20stress%20test/EBA-ST-2011-004-%28Detailed-Methodological-Note%29_1.pdf

21. The methodology applied to the stress testing of net direct positions is clearly explained in paragraph 202 of the Methodological note stating that this methodology applies both for the application of stress test and disclosure of sovereign exposures. The methodology clarifies that for stress testing purposes, the exposures to be stressed should be gross exposures (long) net of cash short position of sovereign debt to other counterparties only where there is maturity matching. This will be referred to as the net direct position. The stress is applied to direct positions net of cash short positions and net of provisions. **To avoid any confusion, in the analysis (and stress test) net direct exposures, both for the banking and trading books, cannot be reported as negative value and are floored to zero for both the stress test exercise and the disclosure documents.**
22. As offsetting is allowed only for cash short positions, which are normally booked in the trading book, this would also affect total net direct sovereign exposures as they include both banking and trading book and offsetting across books would also lead to capping of total net direct exposures.
23. The EBA recognises that the approach chosen does not reflect the actual economic position of the banks, who might have cash short positions in their books (trading books), mostly for the purposes of market making. However, the EBA believes that not allowing net short positions is a prudent approach to the application of the stress test. The EBA is also aware that market analysts would tend to apply haircuts to all exposures (not only trading book), therefore the application of haircuts to negative positions may lead to understated losses. It should be also noted that the EBA haircuts have been specifically designed to be applied only to fair valued debt securities and were not intended to be applied to securities valued at amortised costs held in banking books. Banks may disclose their true economic positions outside the EBA disclosures, which aim at consistent and conservative approach used also in the stress test.
24. In addition, the table covers direct sovereign exposures in derivatives, which are presented as net position at fair values (derivatives with positive fair value plus derivatives with negative fair value). The direct sovereign exposures in derivatives include derivative contracts (e.g. interest rates swaps) in place between the bank and sovereign counterparties (immediate borrower basis approach). The net position at fair values is then the difference between positive and negative fair value.
25. The indirect sovereign exposures in the trading book also presented as net position at fair values (derivatives with positive fair value plus derivatives with negative fair value). The indirect sovereign exposures in derivatives include the net fair value (positive net of negative) of the banks (e.g. CDS) on sovereign risks. Such positions are used by the banks to take risks (protection seller) or hedging (protection buyer).

Differences with the BIS public sector foreign claims data

26. The EBA also notes that sovereign exposures published by EBA in connection with the results of the stress test must not be confused with the figures on public sector foreign claims contained in the BIS consolidated banking

statistics (reported on an ultimate risk basis). The EBA continues to use the same definition used by the CEBS for the purposes of disclosure of sovereign exposures in the context of the 2010 EU-wide exercise. The major differences between two data sets have been explained by the BIS in the December 2010 Quarterly Review⁴.

27. The major differences can be summarised as follows:

- different reporting population (more banks in the BIS reporting);
- gross vs net positions (offsetting of cash short positions in the EBA net direct positions category as described above, whereas BIS focuses on the asset side of banks' trading books);
- risk transfers (immediate borrower basis in the EBA data and ultimate risk basis in the data used in the BIS reporting);
- consolidation across national jurisdictions (for example, the claims of a bank in country X that is owned by a non-bank financial company from country Y will be reported as claims of country X in the BIS data and claims of the non-bank financial company from country Y in the EBA data);
- composition of public sector/sovereigns (in the EBA definition, it includes exclusively "central and local governments", whereas in the BIS definition, it includes "the general government, central banks and multilateral development banks");
- reporting currencies (euro for the EBA data and USD for BIS data);
- treatment of derivatives positions.

Some specific topics regarding individual templates

Funding costs in worksheet "1 – Aggregate information"

28. Funding cost (bps) is the average of the interest expenses weighted by the value of the different funding sources (deposits, wholesale, interbank and central banks).

29. As detailed in the EBA Methodological note, the banks have applied the increase in the interest rates envisaged in the macro-economic scenario, including the assumed rise in the bank's credit spreads (in perfect correlation with the evolution of credit sovereign spreads), taking into account their specific funding and maturity structure (fixed, floating) and hedging strategy.

⁴ See http://www.bis.org/publ/qtrpdf/r_qt1012.pdf and http://www.bis.org/publ/qtrpdf/r_qt1012w.htm