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2018 EU-wide stress test: Frequently Asked Questions

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## Key features of the 2018 EU-wide stress test exercise

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

The EU-wide stress test serves as a common foundation on which national authorities can base their supervisory assessment of banks' resilience to relevant shocks, in order to identify residual areas of uncertainties, as well as 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. Who is involved?

The EU-wide stress test is initiated and coordinated by the EBA and undertaken in cooperation with the Competent Authorities (the Single Supervisory Mechanism (SSM) for the euro area banks), the European Central Bank (ECB), the European Systemic Risk Board (ESRB). The 2018 exercise covers a sample of 48 banks - 33 from SSM countries - representing about 70% of EU banks total assets. The EU-wide stress test will be conducted on the highest level of consolidation (group level).

### 3. How does it work in practice?

The EU-wide stress test is a bottom-up exercise. This means that the EBA develops a common methodology, which is applied by all the banks using their internal models. 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.

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

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

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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 Competent Authorities and the Single Supervisory Mechanism?**

The ESRB and the ECB, in close cooperation with Competent Authorities, the EBA and national central banks, are responsible for designing the adverse macroeconomic scenarios. The ECB also supplies the macroeconomic baseline scenario. 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 the resulting supervisory actions.

#### **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' results will be quality assured and challenged by the CAs. This can lead to resubmissions and possible additional iterations. The EBA expects to publish the results of the exercise by 2 November 2018.

## **Key Methodological Features**

#### **7. What are the key features for the 2018 EU-wide stress test exercise?**

The exercise will be similar to the one conducted in 2016 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 novelty of the 2018 exercise is the incorporation, for the first time, of the IFRS 9 accounting standards.

#### **8. How will the IFRS 9 affect the methodology?**

Banks starting to report under IFRS 9 in the first quarter of 2018 are requested to forecast credit impairments under the adverse scenario based on the expected credit loss framework of IFRS 9. Therefore, banks are requested to account for credit impairments not only for a 12-month perspective but also based on the lifetime credit losses.

#### **9. 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 a rigorous assessment as well as on the comparability of data. To this end, two elements are crucial: (1) a common methodology and consistently applied constraints, such as a static balance sheet, which will provide

market participants and institutions with a common exercise to contrast and compare EU banks under adverse market conditions; (2) a common baseline and adverse macro-economic scenario. In addition, the EBA will provide comparative analysis at the end of the quality assurance process run by Competent Authorities and the bank results will be discussed in the framework of colleges of supervisors involving home and host authorities, as well as the EBA.

## Stress Test Scenarios

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

The 2018 stress test shows a higher degree of severity compared to the 2014 and 2016 exercises. The deviation of the EU real GDP under the adverse scenario compared to the baseline is higher than the previous stress tests. Compared to the Comprehensive Capital Analysis and Review exercise run by the FED in 2017, the severity of the EBA stress test scenario falls between the adverse and severely adverse scenarios. The adverse scenario was designed in a well-balanced manner and in order to be internally consistent but also relevant for all jurisdictions. To this end, additional domestic real and financial shocks have been applied to some countries to increase the severity of the GDP deviation from the baseline so that the cumulative GDP growth under the adverse scenario is negative. However, these additional shocks are not intended to reflect any specific imbalance or any increase in the sensitivity of those countries to a given shock.

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

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

- a deviation of EU GDP from its baseline level by 8.3% in 2020, due to increased global uncertainty and changes in market participant expectations;
- an increase in unemployment of about 3.3 percentage points by 2020;
- a fall in the Harmonised Index of Consumer Prices (HICP) in the EU under the adverse scenario below the baseline level of 1.9% in 2020;
- a decrease in residential property prices by 27.7% below the baseline by 2020 and a cumulative fall in residential property prices over the scenario horizon about 19% at the EU aggregate level.

### 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.

## Disclosure

### **13. 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

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

The 2018 EU-wide stress test will be one crucial piece of information in the SREP process in 2018. 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 be above the applicable capital and liquidity requirements.

For crossed-border banks, the results of the stress test forms a vital information for SREP purposes. Therefore, these will be discussed within the framework of the dedicated colleges of supervisors. Any measures affecting additional own funds requirements (Pillar 2 requirements), will be jointly agreed by the members of the colleges, as required under the legislation of joint decisions on institutions-specific prudential requirements