EUROPEAN BANKING AUTHORITY

Introductory remarks –
EBA-IMF Colloquium, New Frontiers on Stress Testing

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Introductory remarks by Andrea Enria, Chairperson of the EBA

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Check Against Delivery
Seul le texte prononcé fait foi
Es gilt das gesprochene Wort

It has been almost six years since the EBA published the results of its first EU-wide stress test exercise. Since 2011, the EBA has conducted three stress test exercises, in 2011, 2014 and 2016, and a recapitalisation exercise in 2011/2012. We are now in the preparatory phase for the next EU wide stress test, which we will run in 2018. Although the EBA exercises have not been exempt from some criticism, they have led to a significant strengthening of the capital position of European banks. Detailed disclosure of the results has also reinforced market discipline and contributed to restore confidence in the financial sector after the crisis.

European banks have increased their ratios of capital of the highest quality by more than 400bp since December 2011, from an aggregate 9.2% core tier 1 ratio in December 2011 to 14.1% CET1 ratio in September 2016; common equity has soared since 2011, with increases of €180bn in the period from December 2013 to December 2015. Major EU banks' capital ratios are now comparable to their US peers.

It is also important to underline the merit of disclosure, which proved to be a valuable instrument during the sovereign crisis. Perfect knowledge and transparency are preconditions for competitive markets, helping investors to price risk and assess assets. On the contrary, lack of information, poor comparability of the scarce data available, and concerns on the reliability of the information disclosed – as it was the case at the peak of the crisis – can lead market participants to think the worst of each and every bank. In turn, such perception of a high level of risk of banks is conducive to freezes in funding markets, which may also damage banks which are in relatively good conditions, thus hampering the ability of the whole banking sector to fulfil its basic functions.

The publication of our stress test results has been traditionally very detailed, with a large amount of bank-by-bank actual data and projections. This underpins the EBA's ongoing efforts to foster disclosure and market discipline in the EU internal market; provides transparency on banks' exposures; helps to address uncertainties that may affect the EU banking sector as a whole, contributing to a higher confidence by stakeholders; and facilitates comparability across banks.

I was extremely pleased when the IMF offered us to organise jointly this Colloquium. We are very happy to host the conference and to have you here today to discuss the new frontiers on stress testing, and the challenges that this kind of exercise may imply, from a technical, policy and logistical perspective. I am sure that your thoughts and advice will be of great help for us going forward, and in particular in the preparation of the 2018 EBA exercise.

While we are proud of what we have achieved and the progress made, we have to acknowledge that stress testing – certainly in the EU – hasn't reached yet a steady state and there remain some challenges.

Communication is key, as the expectations generated by this type of exercises are sometimes set too high. We should never forget that the stress test is a hypothetical exercise that offers a forward looking view under very specific assumptions. It is an important diagnostic tool available to policy makers but it does not provide answers to each and every questions. The scenarios – however severe – cannot encompass all the potential risks that each bank might come to face. This is particularly the case in an EU wide exercise, which involves many banks from different countries and specific business models, each of them with its own peculiar risk profile and exposure to idiosyncratic shocks.

The EBA exercise is based on a general macroeconomic downturn scenario over a 3-year horizon. While the scenario is linked to a specific trigger, the stress impact is driven by the severity of the overall shock over three years. Any given significant shocks will likely cause a recession which would translate into bank losses. It is crucial to communicate this properly, so that market participants understand that even if specific risks that may arise and materialise during the course of the exercise are not included in the scenario, it remains relevant for the purpose of the exercise. We have a long experience of events that cast doubt on our macroeconomic scenarios, from the sovereign debt crisis in 2011 to the UK referendum in 2016. This, however, doesn't detract from the usefulness of the stress test as a supervisory tool, provided that its limitations are clearly understood and communicated. Rather, it emphasises that stress testing should be viewed as one important tool amongst a number of supervisory tools. Last year, we put very much emphasis, for instance, in explaining the move away from a pass-fail exercise typical of a crisis situation to a supervisory stress test, more suitable for ordinary times.

Governance is also difficult, in any stress test but particularly in a region-wide setting. The EBA stress test exercises involve many actors and it is run under tight deadlines. The role of the EBA as coordinator, developer and guardian of the methodology needs to be reconciled with a legal framework in which we have a very limited role in assuring the quality of banks' results. This is not a justification, but another factor to consider in designing the stress test. Indeed, compared to the US for instance, our methodology is based more on ex-ante detailed instructions and constraints rather than ex-post review of banks' assumptions.

In 2016, we moved from a crisis stress test, where the aim was to identify capital shortfalls and recapitalisation needs, to a supervisory exercise, where the objective is to assess the resilience of banks and their capital planning. This has somehow alleviated the concerns linked to the lack of a EU public backstop – one of the main limitations in 2011 – and has instead required a joint effort for pursuing a coordinated supervisory response across multiple jurisdictions. Still, it would be helpful to move to a common understanding and an integrated framework for deploying public intervention to banks that are in clear need of being recapitalised as a result of the exercise.

We are currently in the process of updating the methodology for the 2018 exercise. Over time, and learning from previous experience, we have strived to enhance and broaden the scope of risks covered in the stress test. In 2016 we added specific provisions on conduct and other operational risk – quite neglected in the past – and also improved the methodology on the cost of funding. For the 2018 exercise, the main methodological change – and undoubtedly a major technical challenge – will be linked to the impending entering into force of the new accounting treatment of impaired assets under IFRS 9. This will have a substantial impact on credit risk and is expected to be challenging for banks, which will be called to adjust their starting point for the stress test but also to implement the new accounting framework in estimating provisioning levels under the adverse scenario.

We have some time – also for discussing with the industry the way forward –, but not too much time. The 2018 exercise is expected to be launched at the beginning of 2018, with publication of the results in mid-year.

Let me conclude by quoting Charles Goodhart: "the conclusion here is that, fallible as they may be, the conduct of annual stress tests gives the regulatory authorities their best available chance of dealing with fragile banks while there is still enough time to avert a, potentially contagious, failure". I look forward to listening to your views on this and your discussions today and tomorrow.

Thank you very much for your attention.