EUROPEAN CENTRAL BANK

BANKING SUPERVISION

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# Stress test in the 2014 SSM Comprehensive Assessment

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**Stress Testing: Where to go from here?**

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# Main features of the 2014 EBA/ECB stress-test

- Purpose:
  - Identifying trends, potential risks and vulnerabilities
  - Strengthening banks' balance sheet
  - ⇒ **Micro-prudential exercise** (which can provide useful input to macro-prudential analyses)

- Main features of the macro-financial scenario:

| 1. Abrupt reversal in risk aversion: | 2. Further weakening of EU real economic activity: | 3. Stalling policy reform: | 4. Lack of necessary balance sheet repair: |
| --- | --- | --- | --- |
| **Global increase in long-term bond yields** | **Further deterioration of credit quality in the EU** | **Re-widening of EU sovereign bond spreads** | **Funding difficulties for banks** |

  - **Severity** of the scenario was broadly in line with the 2014 CCAR
  - **3-year** horizon

# Methodology of the 2014 EBA/ECB stress-test

- The stress-test had a **strong Bottom-Up (BU) component with Top-Down (TD) challenge**
  - BU results were provided by banks, following EBA methodological constraints
  - ECB developed a TD model, based on banks' aggregate data, to challenge banks' results
  - "Comply or explain" approach
  - Qualitative review of banks' projections and explanatory notes

- **"Hard" methodological constraints** were put on banks' projections:
  - Cap on Net Interest Income and floor on RWA
  - Floor on cost of funding and cap on pass-through to lending rates
  - Haircut on sovereign exposures
  - Transition matrix for the risk-weights of securitized products

- **Benchmarks for credit risk parameters** were shared with banks

# Main results of the 2014 Comprehensive Assessment

- **Decrease of the CET1 ratio** for the median participating bank by **4.0 percentage points** (from 12.4% to 8.3%) in 2016

**Comparison of CET1 ratio impact across ST (in percentage points)**

| Exercise | 2014 EBA/SSM | 2014 CCAR | 2012 Spanish AQR/ST | 2011 EBA ST |
|---|---|---|---|---|
| Median impact on CET1 ratio | -4.0 pp | -2.9 pp | -3.9 pp | -2.1 pp |

*Source: ECB Aggregate Report on the Comprehensive Assessment*

- Main **drivers**:
  - Loan losses accounted for 2/3 of the adverse-baseline gap in CET1 ratios
  - Most of the remaining impact came from Net Interest Income

# Institutional challenges

- **Complex governance** due to the number of stakeholders:

| | EC | ESRB | EBA | ECB/SSM | NCAs |
|---|---|---|---|---|---|
| **Scenario design** | (X) | X | X | X | X |
| **Methodology/Templates** | | | X | (X) | X |
| **Quality Assurance** | | | X | X | X |
| **Communication** | | | X | X | (X) |

- **130 banks, 19 countries**…

# Technical challenges

- **Combining results from Asset Quality Review (AQR) and Stress Tests** was challenging
  - No time for conducting the AQR ahead of the stress-test

- **Lack of long, comparable and granular time series in Europe**
  - Particularly challenging for the production of credit risk benchmarks

- Methodological issue with **banks under restructuring plans**
  - Adjustment to the static balance sheet assumption

- **Extensive data request** at a time when banks were shifting to the new Basel III regime, also for the supervisory reporting

# Way forward

- Build on the **new supervisory reporting** framework

- More importance to the review of **banks' internal stress-testing methodologies and processes**
  - Need to go beyond the validation of bank's qualitative results

- **Additional risks**, where supervisory review could be enhanced:
  - Operational risk (in particular conduct risk)
  - Liquidity risk, as far as not captured already by the increase in cost of funding
  - Supervisory benchmarks for non-interest income (e.g. fees and commissions) should be strengthened, esp. for banks under dynamic balance sheet

# Future stress-testing approaches: Bottom-Up or Top-Down?

- Bottom-Up ST: **carried out by institutions** under supervisory instructions
  - Precision
  - Flexibility
  - Information on banks' internal stress-testing practices

- Top-Down ST: **carried out centrally** without the direct involvement of the institutions
  - Comparability
  - Scalability
  - Higher degree of supervisory control
  - Analysis of second-round effects

- **Practical constraints**:
  - Data restrictions undermine the performance of Top-Down models
  - The assessment of banks' practices is an important input to the SREP

**In the short-term,** the current hybrid approach ("BU with TD challenge") seems better suited. The TD approach might prevail eventually, but only **in the long-term.**

# Background slides

# Main results of the 2014 Comprehensive Assessment

- Capital shortfall of **€24.6 billion** across **25 participating banks (€11.2bn** came from the **stress-test)**