2014 EU-wide Stress Test

Based on Presentations by Piers HABEN & Mario QUAGLIARIELLO

The EU-wide stress test : rationale

- EBA required to initiate and coordinate EU-wide stress tests to assess the resilience of financial institutions to adverse market developments

- Evaluation based on **consistency and comparability** of the outcomes across banks

- **Coordination** with competent authorities and the ECB as part of the preparation of the Single Supervisory Mechanism (SSM)

- Common exercise that facilitates the creation of **benchmarks to contrast and compare EU-banks** under common adverse market conditions:
  - competent authorities provided with a consistent and comparable methodology
  - benchmarks to undertake a rigorous assessment of banks' resilience under stress
  - effective dissemination of outcomes

Overview: Components 2014 EU-wide stress test

Tools

Key features

Quantification of different risk types

Scenario

Data templates

Transparency

Disclosure of results

Cooperation

Process and time line

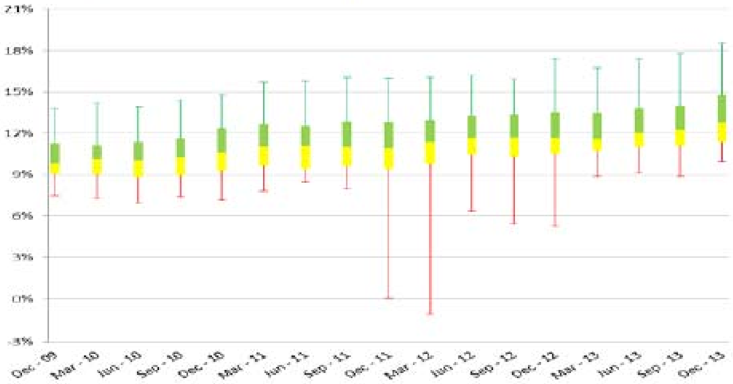
Banks run stress test

Supervisory quality assurance

Supervisory reaction function

Capital evolution- strengthening continues ahead of stress test

Evolution of Tier 1 capital ratio components (December 2009=100), Source: Risk Dashboard



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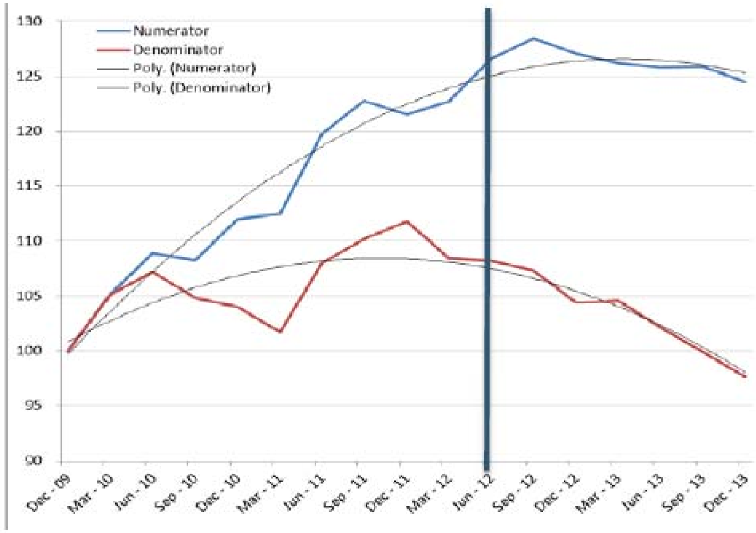
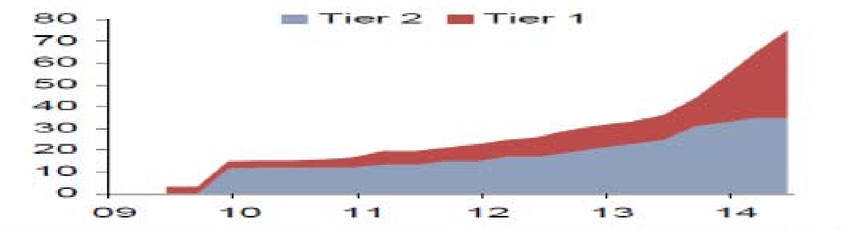


- EU banks' capital positions maintained upward trend in Q4 2013. T1 capital ratio weighted average peaked at **13.1%** (up 0.2 p.p. q-o-q).
- Capital offerings continued in Q4 2013 and first months of 2014, both common equity and hybrids. **Capital raised** – including proceeds from initial public offerings and divestments – is **EUR35bn since July 2013:**
  - **Examples** since July 2013: Italy (EUR 10.2bn); Greece (EUR 8.8bn); Spain (EUR 6.1bn); Austria (EUR 3.4bn).
- **CoCos issuance** around **EUR 13bn (Q12014)**; total **CoCos' market size EUR 73bn and forecast over EUR 100bn in Q42014. 15 AT1 offerings** of European banks in **Q1 2014**, compared to 8 offerings in total in 2013.

Cumulative contingent convertible bonds (coco) issuance, EUR bn



Source: RBS Credit Strategy, Bloomberg

Key features: sample, scope of consolidation, time horizon

Sample of banks

- Banks covering at least 50% of the national banking sector in each EU Member State
- CAs and the ECB can expand the sample if they deem this necessary
- Total of 124 banks (104 EZ, 20 non-EZ)

Scope of consolidation

- Highest level of consolidation – no subsidiaries (the perimeter of the banking group as defined by the CRD/CRR – ie no insurance business)

Time-horizon and reference date

- Consolidated year-end 2013 figures
- Scenarios applied over a period of three years (from 2014 to 2016)

Scenario-ESRB -key features compared to 2011

	ST 2014 (three years)	ST 2011 (two years)
GDP (real growth rate)		
Baseline (cumulative*)	5.3%	3.7%
Adverse(cumulative*)	-2.1%	-0.4%
Deviation (cumulative*)	-7.1%	-4.1%
Unemployment rate		
Baseline (end of period)	10.1%	9.1%
Adverse (end of period)	13.0%	10.5%
Deviation (end of period)	2.9%	1.4%
Equity price change		
Baseline (cumulative*)	N/A	N/A
Adverse(cumulative*)	N/A	N/A
Deviation (end of period)	-19.2%	-15.0%
House price inflation		
Baseline (end of period)	7.4%	N/A
Adverse (end of period)	-16.2%	N/A
Deviation (end of period)	-23.3%	-15.4%
Interest rates (shocks in bps)		
Deviation short-term interbank rates	80	125
Deviation long-term govmt bond yield (end of period)	110	65.8
Maximal deviation long-term govmt bond yields	250	N/A
* cumulative computed as the sum of individual year data		

Key features: definition of capital and hurdle rates

Definition of capital

•**Common Equity Tier 1, with transitional arrangements**, but

- Capital components subject to transitional arrangements (for instance, deferred tax assets, goodwill, etc.) will be reported as memo items and **publicly disclosed**

•**CoCos** - Additional Tier 1 and Tier 2 instruments that convert into CET1 / are written down upon a trigger event reported <u>if the conversion trigger is above the CET1 ratio in the adverse scenario</u>

•CAs may, in addition, assess the impact of the stress test on other yardsticks, including fully loaded CRR/CRD4 Common Equity Tier 1

Hurdle rates

•8% Common Equity Tier 1 ratio for the baseline scenario.

•5.5% Common Equity Tier 1 ratio for the adverse scenario.

•CA may:

- calibrate possible supervisory measures based on a ladder of intervention points
- set higher hurdle rates

Key features: static balance sheet assumption

Static balance sheet assumption

•**zero growth** assumption for both the baseline as well as the adverse scenario

•**assets and liabilities that mature within the time horizon are replaced with similar financial instruments** in terms of type, credit quality and residual maturity

•**no workout of defaulted assets**

•institutions maintain the **same business mix** and model throughout the time horizon

•BUT: CAs may analyse banks’ response functions and managerial actions for mitigating the impact of the stress test as part of the process for identifying supervisory measures

•Exemptions due to the likely completion of mandatory restructuring plans that have been publicly announced before 31.12.2013 (restructuring plans formally agreed with the EU Commission

Key features: risks covered

Risk coverage

- Solvency stress test – no liquidity
    - Credit risk
    - Market risk
    - Sovereign risk
    - Securitisation
    - Cost of funding
- CAs may include additional risks, but
- banks required to submit to the EBA the results based on the common set

Key features: treatment of risks

Overview on stress testing methodology

•Credit risk covers all counterparties (e.g. sovereigns, institutions, financial and non-financial firms and households) and all positions exposed to risks stemming from the default of a counterparty.

•Credit risk will be assessed through the impact of the economic scenario on default and loss parameters

- Provisions
- RWAs

•Market risk covers all positions exposed to risks stemming from the changes of market prices

- common set of stressed market parameters to positions held for trading, available for sale and designated at fair value through profit and loss – including sovereign positions

•Prudential filters for sovereign exposures under the discretion of the competent authority, but <u>approach and impact disclosed</u>

Funding costs- Constraints imposed in three steps

Sovereign spread → **Funding costs** → **Lending rates**

Sovereign spread

- Banks are required at a minimum to reflect the changes in their domestic sovereign bond spreads in the funding costs

Funding costs

- Wholesale funding costs should be adjusted by at least 100% of the change in sovereign bond spreads at the appropriate maturity
- At a minimum 50% of the increase in sovereign bond spreads (relevant maturity) should be passed through to corporate deposits rates
- At a minimum 30% of the increase in sovereign bond spreads (relevant maturity) should be passed through to household deposits rates

Lending rates

- Banks should not assume an ability to pass through more than 75% of the increase in marginal funding costs to new lending
- For residential mortgages banks should instead apply a cap of 50%

Key features: timeline and governance

Who does what

- **EBA**
  - common methodology, scenarios, templates
  - data hub for the final dissemination of the common exercise
  - to provide common EU benchmarks for the purposes of consistency checks
- **CAs and the ECB:**
  - responsible for the quality assurance process, and for communicating any additional sensitivities and the supervisory reaction function
  - assessment of the reliability and robustness of banks’ assumptions, data, estimates and results

Pros & Cons

Strengths:

- Comparability (with changes on the initial rules)
- Necessary to begin with the supervisory duty of ECB
- Help to CA to orientate their supervisory task
- Some ability to anticipate problems

Weaknesses:

- Static analysis on December 2013 financial position
- The test is carried out on capital (what about leverage and liquidity?)
- Is there some possibility to manipulate the results?
- Forecasting value: false positives and false negatives

Timeline

Tentative timeline:

- **3rd March – 21st March**: discussion with the industry on methodology and templates
- **24th March – 4th April**: template's test phase with volunteer banks
- **Mid April – mid May**: advance data collection
- **Mid May – end May**: benchmarks production (EBA)
- **Mid May – mid July:** launch of the exercise: banks calculate stress test impacts
- **Early August:** feedback to CAs on quality checks (EBA)
- **August:** Quality assurance / challenge of the results by Cas
- **End August**: data resubmission to EBA
- **Early September – Mid October**: Preparation of disclosure: templates, consent forms…
- **16th – 17th October** – BoS endorsement ST disclosure and report
- **Mid October** – Results published

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