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European Union-Wide Stress Test: Frequently Asked Questions

European Banking Authority (EBA)

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2014 EU-wide stress test: FAQs

2014 EU-wide stress test: Frequently Asked Questions

Scope

▪ **Why does the EBA run an 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 production of consistent and granular data on a bank by bank level illustrating how balance sheets are affected by common shocks.

▪ **Who is involved?**

The EU-wide stress test is initiated and coordinated by the EBA and undertaken in cooperation with National Competent Authorities (CAs), the European Central Bank (ECB), the European Systemic Risk Board (ESRB) and the European Commission (EC). This exercise is conducted by all competent authorities across the EU on a sample of banks covering at least 50% of the national banking sector in each EU Member State.

▪ **How does it work in practice?**

The EBA develops a common methodology that is applied, in a bottom up fashion, by all the EU banks in the sample. The EBA also acts as a data hub for the final dissemination of the outcome of the common exercise. National Competent Authorities (CAs) and the ECB are responsible for the quality assurance process, as well as for communicating any additional sensitivity (on top of the common EU-wide scenario) and the supervisory reaction function. The EBA supports the CAs' quality assurance process providing EU-wide benchmarks on the main risk parameters.

▪ **Why have EU banks started their repair process ahead of the stress test?**

Rather than being a mere pass or fail exercise, the aim of the stress test is to support the ongoing monitoring and repair of EU banks' balance sheets; and to this regard, the extensive

frontloading that some EU banks have already undertaken ahead of the stress test is a positive result.

The level of transparency provided by the stress test will allow market participants to see for themselves the sensitivities of EU banks to stress, as well as the full range of supervisors responses put in place. In this sense transparency will help restore the confidence of market participants in the EU banking sector.

Process and roles

▪ **What is the role of the EBA?**

The EBA is responsible for developing and providing Competent Authorities (CAs) with a consistent and comparable methodology to allow them to undertake a rigorous assessment of banks' resilience under stress. The ESRB will provide a common scenario on which the stress test can be run. The EBA will also provide CAs with EU benchmarks on risk parameters for the purposes of consistency checks. Furthermore, the EBA will act as a data hub for the final dissemination of the common exercise, thus ensuring transparent and comparable disclosure of banks' results. Finally, the EBA will play a key role in ensuring effective communication and coordination between home and host authorities in the framework of colleges of supervisors.

▪ **What are the roles of national Competent Authorities (CAs) and the ECB?**

CAs and the ECB are responsible for ensuring that banks correctly apply the common methodology developed by the EBA. In particular CAs and the ECB are responsible for assessing the reliability and robustness of banks' assumptions, data, estimates and results. Furthermore, CAs and the ECB are responsible for the quality assurance process, as well as for communicating any additional sensitivity (on top of the common EU-wide scenario) and for the resulting supervisory actions such as capital raising, dividend restrictions etc.

▪ **How will the EU-wide stress test interact with Asset Quality Reviews (AQRs)?**

Asset quality reviews (AQRs) are being undertaken across the EU in 2014 and the outcomes of these AQRs may helpfully inform the starting point for the stress test. The technical details on how the results of AQRs will be linked to the stress test are developed by CAs.

AQRs are a prerequisite for stress tests since they ensure the reliability of the starting point. The EBA issued a recommendation on asset quality reviews (<https://www.eba.europa.eu/-/eba-publishes-final-draft-technical-standards-on-npls-and-forgbearance-reporting-requirements>) to contribute to a more uniform approach in competent authorities' evaluations of banks' credit portfolios but CAs are responsible for determining the modalities of the AQR. The AQR should include risk classification and provisioning and support sufficiently prudent capital levels and provisions to cover the risks associated with these exposures. AQR results should inform the starting point for the stress test.

▪ **What banks will be involved in the stress test?**

The 2014 EU-wide stress test exercise will be carried out on a sample of banks covering at least 50% of the national banking sectors in each EU Member State, as expressed in terms of total consolidated assets as of end of 2013. It will include 124 EU banks from 22 EU Member States: <https://www.eba.europa.eu/-/eba-announces-key-features-of-the-2014-eu-wide-stress-test>

- **How will failing banks be treated?**

National CAs and the ECB for euro-area countries are in charge of quality assurance and therefore of challenging banks' results and ultimately of determining and taking any supervisory action needed.

Timeline and disclosure

- **What is the timeline for the stress test?**

The EBA expects to publish the final results of the 2014 EU-wide stress test in October 2014. The timeline has been agreed and coordinated with the ECB and is, therefore, in line with the overall timeline of the Single Supervisory Mechanism (SSM) Comprehensive Balance Sheet Assessment.

Data templates and guidelines will be distributed immediately after the launch of the methodology and scenarios in April 2014. Advance data collection will be started immediately to be completed end of May. First preliminary results are expected to be submitted to the EBA in mid-July and near-final results tentatively early September for the final round of quality checks and then absolute finalisation of the results will be just ahead of publication. Precise deadlines for the data submission of banks will be defined and communicated by the CAs.

- **How will data and results be published?**

The most important aspect of the EBA's common EU-wide exercise will be the disclosure of comparable and consistent data and results across the EU. Results will be disclosed on a bank by bank basis and the EBA will act as a data for the final dissemination of the outcome of the common exercise. The level of granularity of the data disclosed will be at least consistent with that of the 2011 EU-wide stress test and 2013 EU-wide Transparency Exercise. It will include the capital position of banks, risk exposures and sovereign holdings.

The credibility of the EU-wide stress test rests on transparency; market participants will be able to determine for themselves how supervisors and banks are dealing with remaining pockets of vulnerability.

Methodological aspects

- **What definition of capital will be used?**

The impact of the EU-wide stress test will be assessed in terms of Common Equity Tier 1 (CET1) as defined in the Capital Requirements Regulation (CRR)/Capital Requirements Directive with transitional arrangements as per December 2014, December 2015, and December 2016.

While CET1 is the only eligible capital for covering stress test losses, banks are also required to report additional Tier 1 (AT1) and Tier 2 (T2) instruments that convert (or are written down) if CET1 ratio after the stress falls below the trigger level of these instruments. Since the supervisory reactions rest in the hands of national competent authorities, CAs will decide how to consider this in their reaction functions.

▪ **What will be the treatment of banks' sovereign assets?**

The scenarios will affect the price of all sovereign security positions. Those securities held in the trading book will be subject to a mark-to-market treatment with losses realised immediately. Those sovereign assets held as hold to maturity or loan portfolio positions will be subject to a shift in the risk weights and impairment estimates based on assessments of changes in credit risk. The treatment of securities that are held as available for sale are not included in the credit risk scope and are subject to a fair value treatment. Prudential filters will be treated consistently across the sample of banks, with a gradual phasing out, in order to further enhance the credibility and comparability of the results.

▪ **What is the common approach on prudential filters?**

For the purpose of the EU-wide stress test a common approach for the application of prudential filters for assets in the AFS portfolio, including sovereign exposures, is required across all EU-countries. 'Minimum' transitional requirements as set out in Part Ten, Title I of the CRR apply to all EU countries independent of national derogations, e.g. including 20% of unrealised losses in 2014, 40% in 2015 and 60% in 2016. The impact on the stress test results will be publicly disclosed. Exposures are covered in accordance with their current accounting treatment under the credit risk section (amortised cost approach, e.g. held to maturity securities positions) or/and market risk section (mark-to-market approach, e.g. held for trading, available for sale).

▪ **How will the additional national sensitivities work?**

To enhance the relevance of the shocks for the specific jurisdictions and contribute to a better understanding of idiosyncratic risks in banks a CA can apply system specific shocks on-top of the common EU-wide scenario. National sensitivities might for instance encompass other hypothetical interest rate scenarios or shocks in geographies or sectors of high importance for the national system. However, to ensure comparability the EBA will disclose the results on basis of the common scenarios, while results stemming from those additional sensitivities will be shown separately by CAs. Similarly a CA can apply additional thresholds such as fully phased-in Basel 3 capital ratios, but these will also be presented separately from the common EU wide exercise.

- **How will the EBA ensure consistency between both Eurozone and non-Eurozone countries in the conduct of the exercise?**

The aim of an EU-wide stress test is to assess the resilience of financial institutions across the Single Market to adverse market developments. Consistency in the way the exercise is conducted across the EU is necessary to ensure a rigorous assessment as well as 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 by competent authorities and bank results will be discussed in the framework of colleges of supervisors involving home and host authorities, as well as the EBA.

- **What is the scope of consolidation?**

The EU-wide stress test will be conducted on the highest level of consolidation (group level). Subsidiaries of banks in the European Economic Area are excluded given the Single Market perspective of the exercise. This also explains the difference between the SSM sample, which includes subsidiaries, and the EBA sample.