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Main features of the 2014 EU-wide stress test

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## Background

1. The EBA is required, in cooperation with the European Systemic Risk Board (ESRB), to initiate and coordinate Union-wide stress tests to assess the resilience of financial institutions to adverse market developments. Building on experience of previous EU-wide stress tests, the EBA is conducting a stress test on a wide sample of banks in 2014. This exercise is being undertaken in coordination with national supervisory authorities, the European Central Bank (ECB), the ESRB, and the European Commission under Article 32 of the EBA Regulation. Coordination with the ECB is also of importance, since the ECB in preparation of the Single Supervisory Mechanism (SSM) is conducting a comprehensive assessment comprising of a supervisory risk assessment, asset quality review and a stress test. The main features of the ECB stress test exercise will coincide with the main features of the EU-wide stress test exercise as discussed in this communication.

*"The Authority shall, in cooperation with the ESRB, initiate and coordinate Union-wide assessments of the resilience of financial institutions to adverse market developments. To that end it shall develop:*

- (a) common methodologies for assessing the effect of economic scenarios on an institution's financial position;*
- (b) common approaches to communication on the outcomes of those assessments of the resilience of financial institutions;*
- (c) common methodologies for assessing the effect of particular products or distribution processes on an institution; and*
- (d) common methodologies for asset evaluation, as necessary, for the purpose of the stress testing."*

2. The objective of the EU-wide stress tests is to assess the resilience of financial institutions in the EU to adverse market developments and assess the potential for systemic risk to increase in situations of stress. The evaluation is based on consistency and comparability of the outcomes across banks.

3. The EU-wide stress test is designed to provide supervisors, banks and other market participants and with a common exercise that facilitates the creation of benchmarks to contrast and compare EU-banks under adverse market conditions. Therefore, the exercise is designed to provide competent authorities (CAs) with a consistent and comparable methodology to allow them to undertake a rigorous assessment of banks' resilience under stress and which can be effectively disseminated in a transparent and comparable fashion at an EU level via the EBA. To this end, the EU-wide stress test is focused on providing consistent transparency as a complement, not as a substitute, to other supervisory required stress tests including those carried out under Pillar 2.
4. The 2014 EU-wide stress test (hereafter, "exercise") is conducted on a bank-by-bank basis, at the highest level of consolidation in the European Economic Area (EEA). The assessment of the reliability and robustness of banks' assumptions, data, estimates and results will rest with the CAs and for the SSM countries centrally with the ECB. Banks' calculations should be rigorously reviewed and challenged by the respective CAs and for SSM countries also by the ECB before being collected by the EBA and disseminated for transparency purposes.
5. The EBA will provide CAs with statistical benchmarks for the key risk parameters and variables for assisting the quality assurance process. Although some differences are expected in the way the macro-economic scenarios will be translated by banks into the relevant risk parameters, the results are expected to be substantially consistent for comparable portfolios, institutions and recent historical trends.
6. The EBA notes the specific benefits of a consistent and transparent stress test exercise. At one level it facilitates market discipline, through the production of granular data on a bank-by-bank level illustrating how a common starting point, based on actual data, is affected by a common shock. At the same time an EU-wide exercise can serve as a common ground on which CAs can base their supervisory assessments of banks' resilience to relevant shocks, in order to identify appropriate mitigating actions.

## Objectives of this guidance

7. This document aims at providing banks with the main characteristics of the 2014 EU-wide stress test. A more detailed methodological document as well as the templates for the data collection will be disclosed at a later stage and discussed with the participating banks.
8. The document does not cover the steps of the quality assurance process, which will be managed by the CAs and for SSM countries also by the ECB and rest under their sole responsibility. Accordingly, the note does not deal with possible supervisory measures to be put in place following the outcome of the stress test. Any decisions on the supervisory reaction function will be taken and announced by the relevant CA.

9. CAs may require banks under their supervision to submit additional data for challenging banks' results as part of their quality assurance process.

## Sample of banks

10. The 2014 EU-wide stress test exercise is carried out on a sample of banks covering at least 50% of the national banking sector in each EU Member State, as expressed in terms of total consolidated assets as of end of 2013. CAs and the ECB can expand the sample if they deem this necessary. The full list of banks for the 2014 EU-wide stress test is reported in the Annex.

## Scope of consolidation

11. The EBA exercise will be run at the highest level of consolidation. The scope of consolidation is the perimeter of the banking group as defined by the CRD/CRR. The exclusion of insurance activities is to be done both from the balance sheet and the revenues and costs side of the Profit & Loss (P&L).

## Macro-economic scenarios and market risk shocks

12. The 2014 EU-wide stress test will assess the resilience of EU banks under a common baseline and adverse macro-economic scenario developed in close cooperation with the CAs, European Commission, the ESRB and the ECB. The scenarios will cover the period of 2014 – 2016. Macro-economic scenarios will be agreed by participating authorities.
13. For the treatment of positions held for trading, available for sale and designated at fair value through profit and loss – including sovereign positions in these accounting categories – a set of common stressed market parameters will be directly applied on the positions.
14. CAs may develop additional and specific macro-economic sensitivities and market risk shocks in order to incorporate country specific features as deemed necessary. Banks are however required to submit to the EBA the results based on the common macro-economic scenarios and market risk shocks. The EBA published results should allow understanding the impact of the common scenarios and shocks in isolation, consistently with the objective of ensuring cross-bank consistency and comparability.

## Time-horizon and reference date

15. The exercise will be carried out on the basis of the consolidated year-end 2013 figures and the scenarios will be applied over a period of three years (from 2014 to 2016).

## Definition of capital

16. The impact of the EU-wide stress test will be assessed in terms of Common Equity Tier 1. Additional Tier 1 and Tier 2 instruments eligible as regulatory capital under the CRR provisions that convert into Common Equity Tier 1 or are written down upon a trigger event will be reported as a separate item if the conversion trigger is above the Common Equity Tier 1 ratio in the adverse scenario.
17. The definition of Common Equity Tier 1 that is valid during the time-horizon of the stress test will be used (i.e. CRR/CRD4 definition of capital with transitional arrangements as per December 2014, December 2015 and December 2016). Capital components subject to transitional arrangements (for instance, deferred tax assets) will be reported as memo items and publicly disclosed.
18. CAs may, in addition, assess the impact of the stress test on other yardsticks, including fully loaded CRR/CRD4 Common Equity Tier 1. Possible supervisory measures may be linked to one or more yardsticks at the discretion of the relevant CA.

## Hurdle rates

19. For the purpose of the 2014 EU-wide stress test the following hurdle rates will apply as a minimum across all participating banks:
  - The capital hurdle rate is set at 8% Common Equity Tier 1 ratio for the baseline scenario.
  - The capital hurdle rate is set at 5.5% Common Equity Tier 1 ratio for the adverse scenario.
20. The relevant CA may calibrate possible supervisory measures based on a ladder of intervention points arising from the stress test and may also more formally set higher hurdle rates and formally commit to take specific actions on the basis of those higher requirements.

## Static balance sheet assumption

21. Given its objectives, the 2014 EU-wide stress test will be conducted on the assumption of a static balance sheet. The zero growth assumption applies on a solo, sub-consolidated and consolidated basis for both the baseline as well as the adverse scenario. Assets and liabilities that mature within the time horizon of the exercise should be replaced with similar financial instruments in terms of type, credit quality at date of maturity and residual maturity as at the start of the exercise. No workout of defaulted assets is assumed in the exercise.
  22. The static balance sheet assumption should also be assumed for assets and liabilities denominated in currencies other than Euro, hence the effect of currency fluctuations should not affect the enforcement of this assumption.
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23. Furthermore, it is assumed in the exercise that banks maintain the same business mix and model (geographical and product strategies and operations) throughout the time horizon. With respect to the P&L, revenue and cost assumptions made by banks should be in line with the constraints of zero growth and a stable business mix.
24. While the EU-wide stress test is based on the static balance sheet assumption and the results should be presented accordingly, CAs may deem useful to analyse banks' response functions and managerial actions for mitigating the impact of the stress test as well as variables such as the evolution of credit growth under the scenarios as part of the process for identifying possible supervisory measures for addressing possible capital shortfalls emerged in the exercise.
25. Exemptions from the static balance sheet assumptions can be granted due to the likely completion of mandatory restructuring plans that have been publicly announced before 31<sup>st</sup> December 2013. These restructuring plans need to be formally agreed with the European Commission.

## Risk coverage

26. The EU-wide stress test is primarily focused on the assessment of the impact of risk drivers on the solvency of banks. Both trading and banking book assets (including off-balance sheet exposures) are subject to stress at the highest level of consolidation of the banking group.
27. Banks are required to stress test the following common set of risks:
  - Credit risk
  - Market risk
  - Sovereign risk
  - Securitisation
  - Cost of funding
28. Although the focus of the exercise remains on credit and market risks, banks are also requested to assess the impact on interest income, including the increase in the cost of funding, over the stress-test time horizon. In addition, capital requirements for operational risk are also taken into account in the exercise using a simplified approach.
29. CAs may include additional risks (e.g. sector specific risks, conduct risk) beyond the common set identified for the EU-wide stress test. Banks are however required to submit to the EBA the results based on the common set of risks. The published results should allow understanding the impact of the common set of risks in isolation, consistently with the objective of ensuring cross-bank consistency and comparability.

## Overview on stress testing methodology according to risk type

30. The credit risk section 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 (loan portfolio positions, held to maturity securities positions and – where applicable – positions in the available for sale and designated at fair value through profit and loss). Credit risk will be assessed through the impact of the economic scenario on default and loss parameters.
31. The market risk section covers all positions exposed to risks stemming from the changes of market prices. Market risk will be assessed by applying a 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 in these accounting categories. Credit spread risks in accounting categories sensitive to market risk evolutions are also subject to the stressed market parameters.
32. The use of prudential filters for sovereign exposures is under the discretion of the CA as provided for by the CRR/CRD IV. The approach followed and its impact on the stress test results will be publicly disclosed. Exposures will be 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).

## Tentative timeline and process

33. The process for running the common EU-wide stress test will involve close cooperation between the EBA, the CAs and the ECB. Common agreement on the scenarios, methodology and templates will be followed by direct engagement with participating banks by CAs. CAs will be responsible for conveying the instructions on completing the exercise to banks and will receive information directly from banks. The EBA will coordinate this exercise in cooperation with the ECB (in case of SSM countries) and may host a central Q&A facility. The EBA will act as a data hub for the final dissemination of the common exercise. The EBA will also provide some common EU benchmarks to CAs for the purposes of consistency checks. CAs and the ECB will be responsible for the quality assurance process, as well as for communicating any additional sensitivities (on-top of the common EU-wide scenario) and the supervisory reaction function.

Draft stress test methodology to be circulated to banks and other market participants for feedback. Advance data collection for computing benchmarks for risk parameters	March / April 2014
Publication of final methodology and scenarios	April 2014
Results published	October 2014