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The EU-wide stress test: can the glass be more than half full?

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

1. Introduction

It is probably not an overstatement to say that the EU-wide stress test has been – for good or for bad – one of the most recognisable products of the European Banking Authority (EBA). Since its establishment, the EBA has carried out four such exercises, with the last one finalised in 2018.

Right around this time last year, we published a comprehensive set of data, disclosing the results of the EU-wide stress test for 48 large banks. The data showed that, in aggregate terms, the EU banking sector was resilient to adverse shocks, thanks to the continuous strengthening of capital positions by the major EU banks since 2011. Similar to previous exercises, we spotted some pockets of risks, affecting some banks more than others, and enabled Competent Authorities to consider these vulnerabilities as part of their supervisory review and evaluation process (SREP) and for setting Pillar 2.[1]

We have just finalised the methodology for the 2020 stress test and we are now in the testing phase of the templates for data collection, with the precious support of participating banks.

[1] 2018 EU-wide stress test results (https://eba.europa.eu/eba-publishes-2018-eu-wide-stress-test-results).

As in all the previous years, we engaged with the relevant stakeholders to get feedback on the methodology, results and process. On two separate occasions, we met with banks, once in January 2020 to discuss the lessons learnt, and the second time in September 2020 to collect views on the methodology proposed for the 2020 EU-wide stress test.

While for 2020 we decided to stick to the traditional "constrained bottom-up" approach, we have also started an overall reflection on the need for potential fundamental changes to the EU-wide stress test framework. This has been done in parallel to the preparations for the next year's exercise and we hope to kick-off an open and transparent discussion with the industry early next year. We have already discussed some aspects with the different users of our stress test, including banks, investors, analysts and other international organisations.

Today, I will discuss with you what we have learnt, how we changed the up-coming exercise and possible options beyond 2020.

2. Finalising the preparation for the 2020 EU-wide stress test

Let me start with the short-term developments.

The final 2020 EU-wide stress test methodology was published just a couple of days ago[2], together with draft templates, which will be subject to testing until the end of this month. With the final package in place and the scenario to be finalised, the exercise will be launched by the end of January next year.

The 2020 exercise will be very much in line with the one we ran in 2018. We aimed at keeping the methodology as stable as possible, while improving some aspects based on our lessons learnt and banks' feedback. As we decided not to introduce fundamental changes to the approach, the EU-wide stress test will continue to be constrained bottom-up, a key input for the SREP and a comprehensive disclosure exercise.

The general principle that we followed in the revision process was to simplify the methodology and streamline the templates and, at the same time, clarify aspects that were prone to misinterpretation in 2018. Given the calls – from both banks and supervisors – to reduce the burden of the quality assurance process, in some areas, we reduced the degree of freedom for banks and moved to more mechanistic approaches. This was not an easy choice but we wanted to be clear upfront on which risks were left to banks' internal modelling and which followed a more top-down approach. In turn, the revision should reduce the complexity of the exercise and also avoid frustration when banks' bottom-up results are overridden ex-post.

[2] 2020 EU-wide stress test methodology and draft templates (https://eba.europa.eu/eba-publishes-2020-eu-wide-stress-test-methodology-and-draft-templates).

Let me turn to the main changes by risk type. On credit risk, the methodology went through a significant transformation in the previous exercise with the introduction of IFRS 9. Notwithstanding the concerns raised by banks in 2017, we managed to strike a good balance between consistency with the accounting standards and simplification: overall, the approach worked well. Therefore, except for the implementation of new regulation – namely, the NPL calendar, and the new securitisation framework – and some minor enhancements relative to prior exercises, this part of the methodology did not see major alterations.

The focus, when considering potential changes to the 2020 methodology, was rather on net interest income and market risk. For the former, the quantification of the average point of maturity for assets and liabilities – which in 2018 was based on banks' internal estimations but required significant quality assurance efforts – was standardised. Also, the treatment of sight deposits – which was very convoluted in the previous exercise – was simplified and harmonised. We had also planned a conservative treatment for hedging transactions–surprisingly, a material source of income for banks in the adverse scenario – but we decided not to proceed after discussing it with the industry. Similarly, we considered and then discarded the option to introduce a variable cut-off date for the full-revaluation of the portfolio in market risk. We wanted to mitigate the risk of window-dressing of trading books, but we listened carefully to the views of banks and concluded that the benefits in terms of conservatism did not overweigh the additional effort required from banks. In the end, the main change in market risk was a revised definition of net trading income, standardising it for comparability and level-playing field reasons.

On disclosure, we confirmed our commitment to provide the most comprehensive source of information on EU banks and agreed to start the disclosure of Pillar 2 Requirements (P2R) for each bank. This is the first time P2R will be made public in a systematic way – before, disclosure was on voluntary basis – and, thus, the first time the general public will be able to compare banks' capital levels to their respective capital requirements. I will discuss further implications of this important change later on during these remarks.

We have also introduced some changes to the process, where we tried to accommodate very sensible banks' request to have more clarity ex-ante on milestones of the exercise so that they can set their infrastructure and plans way in advance. The timeline of the exercise has been shortened compared to 2018 and brought back in line with the one we used in 2016. The start of the exercise is end-January and the publication will now take place in July 2020. The exercise will again feature a frequently asked questions (FAQs) process, but this time – and this is the second change – it will be shortened and made more convenient for banks, allowing them not to incorporate answers published too close to the submission date and to do so in the next submission.

Overall, I think, we managed to strike a good balance between implementing some necessary changes and keeping the methodology as stable as possible, while optimising the whole process for both banks and supervisors.

I would like to emphasise that a great deal of these changes were brought up during our discussions with the banks. While we cannot always accommodate banks' requests, we immensely value their

inputs and – even when the outcome may not be what they had hoped for – they may rest assured that each and every contribution has been carefully assessed. If our methodology made banks fully happy, we would not be doing our job properly.

3. Lessons learnt from the EU-wide stress tests

After almost ten years, four exercises and the fifth well on its way, it is the right time to look back and consider what we have achieved but also whether the current setting is still adequate.

It is the first time, I believe, we have engaged in a structured process for discussing the possible evolution of the stress testing franchise and its future trajectory.

I do not want to pre-empt a discussion that is still ongoing and we are facing with an open mind and genuine interest in listening to all views. Nevertheless, let me try to touch on a couple of points that are important to us.

The EU-wide stress test has been successful in increasing transparency across a wide sample of European Banks. It helped discern which banks are weaker and more sensitive to shocks, rank them and explain risk drivers and exposures. The main benefit of undertaking stress tests in a coordinated fashion remains to deliver consistent and comparable outcomes across the Single Market.

Similarly to the US, the results of the EU-wide stress are disclosed on a bank-by-bank basis, but the granularity of information has been traditionally higher. In a more fragmented supervisory community than in the US and with very little bank data available to market participants, the disclosure of figures on a comparative basis represents an innovation, is highly appreciated by market participants and is part of the EBA's mandate.

Another success factor of the EU-wide stress test is how it gradually, but consistently, improved the EU banking sector's resilience. The immediate goal of the stress tests has shifted over time. During the crisis, there were concerns on the level of capitalisation of European banks. The emphasis then was on identifying specific recapitalisation needs in the banking sector and encourage institutions, and in some cases countries, to address them. Now the focus is on better understanding the exposure of different institutions, their resilience, and to help in the supervisory dialogue informing the Pillar 2 decisions.

In any case, the use of a single scenario and consistent methods in the EBA stress test continue to provide an important and unique horizontal snapshot of the capitalisation and soundness of banks. Even today, horizontal comparability remains a significant contribution of the exercise. Therefore, having a transparent process that uses a common methodology and templates is an element that works.

The stress tests have been criticised for not identifying some banks that eventually got into trouble. Predictability of the future may be desirable but not reasonable. The EU-wide stress test did help

supervisors spot weak links and that is proof of its usefulness. As I just said, the first stress tests helped identify banks with capital needs, and capitalisation of the institutions increased. When looking at the results of the EU-wide stress test over time, there are also clear and consistent patterns across how banks perform in the stress tests. Almost half of the most resilient banks – those in the lower quartile in terms of capital depletion – reappear in each of the exercises. Also, underperformers tend to be broadly the same over time and often these are the banks requiring supervisory attention in the aftermath of the stress test. Certainly, this is a simplistic way of interpreting the results: we run one single scenario and some banks or business models could be more affected than others. However, this also shows that we have been rather successful and consistent in ranking banks according to their resilience.

The framework is, however, far from ideal and there are areas where our approach underperforms other stress tests.

First, compared to the US – but also the UK with its own exercise – the EU-wide stress test is less integrated in the regular supervisory process, not least because the EBA is not a banking supervisor. While the stress test serves as an input for the SREP, some methodological constraints – like the static balance sheet assumption – require a follow up discussion between banks and supervisors after the publication of the results. In addition, the outcome of the SREP is disclosed in some cases but not in all jurisdictions. Investors – this is what they consistently tell us – understand the rationale for a non-pass/fail setting, but want clarity on the implication of the stress test in terms of other supervisory decisions, particularly capital distributions.

As I mentioned earlier, the issues above will be partly addressed in the 2020 exercise, with the publication of P2 requirements. This is an important first step.

Second, too many banks interpret the stress test more as a beauty contest for external benchmarking than as a useful tool for assessing their own vulnerabilities and engaging in discussions with their supervisors. According to a stocktake, four out of ten representatives of banks' senior management consider the stress test relevant as a competition tool or as an industry-wide transparency exercise. Furthermore, 60 percent of banks feel that results do not fully reflect their resilience.[3] This makes the exercise less useful for internal risk management but also creates incentives to game the methodology.

The question is whether it is possible to improve the current design of our stress test by addressing some of its shortcomings. The challenge I see is to balance the need to have an assessment that is useful for banks and supervisors with safeguards for ensuring credibility and severity of the results while preserving the information value to the wider stakeholder audience. Basic trade-offs clearly exist. Ex-ante constraints can be relaxed if ex post-reviews are wide-ranging. In this case, the quality assurance process has a pivotal role to play in a more tailor-made, idiosyncratic stress test. However, it is resource intensive, and the number of banks that can realistically take part in it would have to be smaller. This would undoubtedly come at a cost in terms of horizontal transparency and

[3] Quagliariello Mario (2019), "Are stress tests beauty contests? (and what we can do about it)", EBA Staff paper, July 2019. Oliver Wyman (2018), "Supervisory stress testing: evolving for higher value", presentation at EIFR, Paris, December.

level playing field among institutions. Obviously, resources are spent also by banks. For that reason, efficiency, both for supervisors as well as banks will play a pivotal role in deciding on potential changes.

4. 2022 and beyond

The past has proven that our current model works in our complex institutional setting and with the available resources. But it also has shortcomings. At this point, in my opinion, the glass is half full, and the question is: can we do better?

This is why we started a candid and transparent process for assessing possible fundamental changes to the framework. The goal is to do better. We are not obliged to change and we first need to be convinced we can deliver a better approach for all the stakeholders.

I will start recalling the main objectives of our stress test and identifying, which are, in my view, the success criteria for assessing different frameworks.

The EU-wide stress test is a micro prudential exercise whose main objective is the identification of risks for both supervisors and banks. For supervisors, it has become a concrete support to the SREP and to the assessment of capital planning. For banks, it should complement and challenge their internal capital adequacy assessment process (ICAAP).

An important by-product is to disseminate clear and comparable information to market participants on banks' resilience and the ability to generate and distribute profits in an adverse scenario.

The question now is: how to ensure that the stress test achieves efficiently those objectives? There is not a single answer, but I think the new framework should make the EU-wide stress test more relevant, comparable, transparent and less costly.

Relevance implies that the projections should be as close as possible to the actual impact on capital should the adverse scenario materialise. It is clear that projections – since they are based on a limited information set, judgmental assumptions, and imperfect models – are inherently subject to uncertainty. However, we should aim to a framework that limits the incentives for banks to game the methodology – they should provide supervisors with their best, not the smallest, estimate of the impact – and allow supervisors to reduce methodological constraints. This is important since, as I have mentioned, in the current bottom-up approach, there are safeguards that ensure reliability, but to the detriment of realism.

Results should remain comparable across jurisdictions and banks. The EU-wide stress test is – most likely – the largest scale concurrent stress test at the global level, involving a huge sample of heterogeneous banks. I think I do not need to elaborate much on that, but I would like to highlight that strict methodological safeguards have been instrumental to establishing a level playing field across banks.

Transparency is dear to the EBA. This is an element to preserve and reinforce. Disclosure is important to markets for scrutinising banks. Clarity on the linkage between the results and supervisory action, particularly P2G quantification, is a key success criterion when comparing and contrasting options for the future.

And last but not least, we need to find a way to make the entire exercise more cost efficient, in terms of planning, data requirements and quality assurance process.

Two obvious corner solutions would be moving to a fully top down approach conducted by the supervisor or allowing an unconstrained bank's bottom-up approach that would be quality assured by the supervisor. The main problem of the first one is that by using a "one-size-fits-all approach" approach across different banks and jurisdictions you may lose some important information along the lines, meaning that the relevance of the result would be affected. In addition, quite frankly, I think that the current available models are still not in the best shape to delivering comprehensive EU results covering all risks across a variety of business models but remain useful for the supervisory dialogue. Looking at the second extreme solution, the main drawbacks would be lack of comparability along with the massive increase in costs for supervisory quality assurance of the results.

We should probably recognise that the success criteria can be met allowing for two components in the stress test: one under the supervisors' control, possibly leveraging on the current approach, and the other one allowing more flexibility for banks. In such a landscape, the supervisory leg of the exercise would be similar to the current approach, where banks submit their bottom-up projections based on methodological constraints. The bank's leg would allow, instead, banks to make full – possibly unconstrained – use of their models. Both legs would use a common scenario and possibly they would share the same starting points.

This is very much work in progress and no clear way forward has been identified yet, but let me try to explain in more detail how the approach could work in practice.

The supervisory leg would still be a constrained bottom-up approach and it would be the basis for the supervisory decisions. Banks would submit – as they do today – their projections that would be quality assured by supervisors. The key innovation is that supervisors would own this part of the exercise and can form their view on capital depletion in the adverse scenario based on banks' submissions, benchmarking tools, top-down estimates. Banks would not be required to sign off these results and the overall quality assurance process would become lighter for them. Results would be relevant for supervisors and comparable.

The relevance of the supervisory leg could also be improved by relaxing some of the current constraints. On the contrary, for risk areas where banks' overly optimism consistently delivers unreliable results pure top-down features could be introduced. Namely, for some risks, such tools are already well developed.

The bank leg would obviously leverage on the bottom-up approach with less – or potentially no – constraints. The methodology would be much less prescriptive but still contain common templates for reporting. The results would not be quality assured and would be owned by the banks. Less constraints and no quality assurance should make the burden of this component relatively minor.

These two views should form the basis for a fruitful discussion between the banks and their supervisors on what are an institution's most salient areas of weaknesses, and prioritising actions and decisions by the banks.

How to combine the two outcomes and provide adequate disclosure and transparency to that process would be the bigger challenge. Here I can think of two options.

One is reconciling the two assessments in order to end up with a single estimate, to be published in line with today's standards and perceived as relevant for both supervisors and banks. The other option is to keep the two outcomes separate and explain the differences.

Regardless of the path we take, disclosure cannot be less than it is today, ideally better in quantity and quality. This implies publishing results that allow banks to better explain their business models and provide a clear link with the supervisory decisions, including Pillar 2 guidance.

Explaining two separate outcomes could be more complicated but the disclosure could be framed in such a way to make results and their use understandable. In principle, the granularity of the data of the supervisory leg could be reduced since what really matters is the bottom line, the P2G quantification. The outcome of the banks' leg would instead be more idiosyncratic, with granular disclosure, and would inform market participants of the internal assessment of risks in an adverse scenario, possibly including elements of dynamism. In addition, it is important – in my view – the disclosure remains very granular.

These are just ideas. I acknowledge there are plenty of open issues, questions and practical challenges to address. We also need to think on how to improve our current approach to identifying the risks to stress and build the stress scenarios. The number of scenarios to be used, the frequency of the exercise, the sample coverage, as well as how to include climate change and other emerging risks in the stress testing framework should be a substantial part of the discussion.

In addition, as we review our SREP guidelines, stress test will have to be better integrated in the overall assessment of the SREP methodology.

The bottom-up approach has been traditionally the one chosen by the EBA, but as we develop top-down tools along the way, it does not necessarily have to be the only one. In fact, I mentioned before that top-down models for some risks are already robust enough to complement the bottom-up approach at present, preserving relevance and saving costs for both banks and supervisors. While challenging, developing a full top-down model should be an ambition. Furthermore, we should think of how to incorporate ad-hoc targeted stress test analyses in the future framework, allowing for flexibility in assessing vulnerabilities and facilitating the identification of specific risks.

Such practice is already applied in many jurisdictions, but conducting it in a coordinated way across the Single Market would add comparability and commonality to the results.

We also need to assess carefully costs and benefits of the different options.

The immediate goal is to start this discussion in an open and organised manner, and to crystallise the multiple views, trade-offs and plausible ways forward, in an EBA's vision paper, which we can discuss with the industry. This will require time.

While an option is to move to the new framework in 2022, we all agree that we should not rush with such fundamental changes and it is better to delay and get them right rather than committing to an implementation date without a fully satisfying approach.

We aim at publishing this Discussion Paper early next year, presenting the potential changes in more detail and seeking views of the industry.

5. Conclusion

So far, several things are clear. The 2020 EU-wide stress test is under way, the preparations are coming to an end and we plan to launch the exercise at the beginning of next year. As in previous stress tests, this exercise will feed the SREP process and serve as a basis for determining banks' P2G. For that reason, finalising the 2020 exercise is a priority for the supervisors, and for us. Banks should be prepared to another round of this important assessment.

In the meantime, we are working on how to improve the framework in the longer term. The process can take time but I can promise it is going to be very transparent. I cannot exclude that we will eventually stick to what we currently do, if no alternative solutions meet the success criteria to an acceptable extent. But, I am confident we will have a fruitful discussion and manage to make the glass fuller.

I look forward to receiving your feedback, suggestions and ideas.

Thank you very much for your attention.