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2023 EU-wide stress test: Frequently Asked Questions

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Key features of the 2023 EU-wide stress test exercise

1. What is the objective of the EU-wide stress test?

The EU-wide stress test is part of the supervisory toolkit used by Competent Authorities (CAs) to assess the resilience of EU banks to severe shocks, identify residual areas of uncertainties, as well as feed into the supervisory decision-making process to determine appropriate mitigation actions. The stress test also allows CAs to assess if the capital banks have accumulated in recent years, is sufficient to cover losses and support the economy in stressed times. Moreover, the exercise fosters market discipline through the publication of consistent and granular data on a bank-by-bank level, as it shows how balance sheets are affected by common shocks.

2. How does the stress test work in practice?

The EU-wide stress test is mainly a bottom-up exercise. The EBA has developed a common methodology, which is applied by all banks using their internal models. The common methodology allows CAs to undertake a rigorous assessment of banks' resilience under stress. Methodological constraints in several areas limit banks' degree of freedom and ensure a level playing field via the comparability of outcomes across banks. Banks' results are checked, and quality assured by CAs.

3. What is the role of the EBA?

The EU-wide stress test is initiated and coordinated by the EBA and undertaken in cooperation with CAs (including the Single Supervisory Mechanism (SSM) for the euro area banks), the European Central Bank (ECB) and the European Systemic Risk Board (ESRB). The EBA is responsible for coordinating the exercise and for developing a common methodology. The EBA supports the quality assurance process by providing common quality assurance guidelines and EU-wide descriptive statistics on the main risk parameters to enable CAs to perform consistency checks and to undertake a rigorous assessment of banks' results. In addition, the EBA acts as a data hub for the final dissemination of the outcome of the exercise, thus ensuring transparent and comparable disclosure of banks' results. Finally, the EBA plays a key role in ensuring effective communication and coordination between home and host authorities in the framework of colleges of supervisors.

4. What are the roles of the ECB, the ESRB, the national CAs and the SSM?

The ESRB, in close cooperation with the ECB, CAs, the EBA and national central banks, is responsible for designing both the baseline and adverse macroeconomic scenarios. The baseline for EU countries is based on the December 2022 projections from the national central banks[1], while the adverse scenario is developed by the ESRB's Task Force on Stress Testing in close collaboration with the ECB and is approved by the ESRB General Board.

CAs, including the SSM, are responsible for ensuring that banks correctly apply the common methodology developed by the EBA. In particular, CAs and the SSM are responsible for assessing the reliability and robustness of banks' assumptions, data, estimates and results. Furthermore, they are responsible for determining the resulting supervisory actions.

5. Which banks are involved in the exercise?

The 2023 exercise covers a sample of 70 banks - 57 from the Eurozone - representing about 75% of EU banks' total assets. Compared with previous EU-wide stress tests, the 2023 exercise covers 20 more banks, which is an increase of 40% in terms of covered banks. The EU-wide stress test is conducted at the highest level of consolidation (group level).

6. What is the timeline for the stress test?

After the launch of the exercise, banks will estimate the impact of the adverse scenario on their balance sheets and will provide several submissions of the stress test results to CAs and the EBA. These submissions are quality assured and challenged by the CAs. The EBA expects to publish the results of the exercise by the end of July 2023.

Key methodological features

7. What are the specificities and key features of the 2023 EU-wide stress test exercise?

The 2023 exercise is based mainly on bottom-up projections from banks subject to constraints and a static balance sheet approach. The methodology has undergone some important enhancements compared to the one used for past stress test exercises. These enhancements include the incorporation of lessons learnt from the previous exercise, the introduction of top-down elements for net fees and commissions income (NFCI), as explained in FAQ 9, more detailed sectoral analysis, and an increased sample with larger coverage, as mentioned above. The changes are part of the medium-term plan of revising the stress test framework.

For credit risk, banks will have to provide, for the first time, a breakdown of their exposures towards firms and the related impairment by sector of economic activity. In order to do so, they should to the extent possible rely on sectoral models or apply sectoral sensitivities to portfolio-level projections. The check for consistency between the projections for corporate exposures at

[1] For non-EU countries, the baseline macro-financial scenario is based mainly on the projections from the October 2022 International Monetary Fund (IMF) World Economic Outlook and data from the Organisation for Economic Co-operation and Development (OECD).

aggregate level and the sectoral breakdown will form part of the quality assurance by CAs. In parallel, the scenario has been enriched with the growth rate of the gross value added for each sector, which is differently affected by the economic developments considered in the scenario (see FAQ 14).

As part of the enlargement of the sample, the EBA has introduced additional proportionality elements. These elements can be applied by banks that enter the sample after broadly 70% coverage of the banking sector is reached. The proportionality elements allow a more simplified approach in assessing risks with lower reporting requirements and, therefore, foster efficiency gains to banks that apply them.

Furthermore, the reference rate pass-through on sight deposits from households and non-financial corporations has been recalibrated to increase the realism of the exercise.

8. Why has a sectoral breakdown been introduced for credit risk?

The main purpose of the breakdown by sector is to ensure that the results of the stress test reflect banks' exposures towards different sectors, thereby increasing the credibility and realism of the exercise. The inclusion of the breakdown by sector in this year's stress test for the first time will provide learnings for its refinement for future EBA stress tests. Banks should reflect the breakdown of the scenario by industry sectors in their stress test projections (see also FAQ 7 and 14).The motivation for introducing the sectoral dimension in the stress test is in part the desire for increased supervisory scrutiny of banks' exposures to certain economic sectors against the background of more frequent supply chain disruptions following the pandemic and the higher vulnerability of energy-intensive sectors after the surge in energy prices following the war in Ukraine. Events like the Covid-19 pandemic or recent geopolitical developments have proved that the impact across economic sectors can vary significantly.

9. How will the methodology for projecting net fees and commissions income differ from previous exercises?

This projection will follow a top-down approach. Banks will be required to make use of prescribed growth rate parameters when projecting their net fees and commissions income. The parameters will be produced with a supervisory model and will be provided to banks by the EBA via banks' Competent Authorities. The initial model was developed by the ECB and has been validated by the EBA and National Competent Authorities to ensure its suitability for the purposes of the EU-wide stress test. To reduce model risk, the raw model projections are subject to a model overlay. The overlay takes the form of a "corridor" with a maximum and minimum permissible decrease of cumulative NFCI (cap and floor).

10. Why has a top-down model for NFCI been introduced in the methodology?

The introduction of top-down elements for the projections of net fees and commissions income is part of the EBA work on the future changes to the EU-wide stress test. This methodological change aims at reducing costs for both banks and supervisors.

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

The exercise is conducted across the EU. Therefore, its consistency relies on the common methodology, same scenario, and a rigorous assessment of the granular transparency of results and underlying data. In addition, the EBA will conduct a comparative analysis at the end of the quality assurance process run by CAs. The bank results will also be discussed in the framework of colleges of supervisors involving home and host authorities, as well as the EBA.

Key features of the stress test scenarios

12. How different is this year's scenario compared to the previous exercises?

Similar to previous exercises, the narrative of the adverse scenario for the EU-wide banking stress test reflects the main risks for EU banks that have been identified by the EBA and the ESRB. The assumed materialisation of these risks triggers widespread substantial corrections in asset prices and a severe decline in GDP over the horizon. Contrary to past exercises, the adverse scenario implies the persistence of high inflation over the horizon and, as a result, much stronger market interest rates. As usual, the adverse scenario is hypothetical, based on a set of severe assumptions meant to generate adequate stress.

13. What are the key features of the adverse macro-financial scenario?

While the adverse macro-financial scenario is unlikely to unfold it is based on the important premise that although hypothetical it should be severe, plausible and in line with the risk and vulnerabilities that might threaten the EU banking sector. It reflects the high degree of uncertainty in the current economic and geopolitical environment.

The key features of the adverse macro-financial scenario are:

- inflation well above baseline over the whole horizon, by 3 ppts in 2023, 1.9 ppts in 2024 and 1.5 ppts in 2025.
- a market increase of EU long-term interest rates, by 183 bps between the starting point at the end of 2022 and end-2025.
- a severe loss of real GDP for the EU, reaching 6.0% from the starting point in 2022 to 2025.
- a significant increase in EU unemployment rate, of 6.1 percentage points from the starting point in 2022 to 2025.
- a strongly negative deviation of EU stock prices from the starting point, by 55% in 2023 and by 43% in 2025.
- a substantial drop in EU for residential and commercial real estate price from the starting point over the three-year horizon, by some 21% and 29% respectively.

14. Which additional elements are derived from the main macro-financial scenario?

Two elements are derived from the macro-financial scenario: the first one is the market risk scenario, which provides instantaneous shocks for risk factors covering interest rates, FX, equities, commodities, sovereign and corporate credit spreads, volatilities, liquidity reserves and global inflation expectations. The definition of shocks in the market risk scenario is consistent with the narrative of the stress test exercise, although market risk shocks have a different time horizon compared to the macro-financial scenario. Macro-financial adverse shocks have been frontloaded in the market risk scenario, to further enhance the consistency between the two scenarios and enhance the degree of conservativeness of the market risk scenario. The market risk scenario is used by participant banks to stress positions under the scope of the market risk methodology.

The second element is the sectoral decomposition of the adverse macro-financial scenario. For the first time, the EBA stress test exercise will include an assessment of credit risk at the sectoral level (see FAQ 7 and 8). To that aim, the EBA 2023 stress test exercise includes a sectoral breakdown of the macroeconomic scenario for 16 sectors, corresponding broadly to the first level of the Eurostat NACE2 decomposition. To that end, the aggregate real GDP scenario has been broken down into consistent sectoral real Gross Value Added (GVA), reflecting shock- and country-specific vulnerabilities.

15. How severe is the adverse macro-financial scenario, compared to the previous exercises?

Compared with previous exercises, the 2023 EBA adverse scenario is more severe with a cumulative decline of EU GDP from the starting point of 6% over the three-year horizon. For previous exercises, the maximum cumulative decline was 3.6% in 2021 and 2.7% in 2018. In this respect, a major difference compared to the previous scenario are the assumptions for both interest rates and inflation. The 2021 exercise adverse scenario was characterised by a “lower for longer” interest rate environment – along with very low inflation. Instead, the adverse scenario now exhibits high and persistent inflation, which triggers a prompt and strong increase in market interest rates and risk premia, moreover, sustained over the horizon. This configuration contributes to the severity of the assumed macroeconomic picture, by dampening demand via real income and financing cost adverse effects. It also increases the risks of corporate and household defaults for banks, against the background of elevated debt levels already at the beginning of the stress test horizon.

16. What are the assumptions on monetary policy taken in the adverse scenario?

The convention used in the calibration of adverse scenarios for EBA stress tests is one of “no policy change”, which also applies to the 2023 adverse scenario. This means that no other monetary policy and fiscal policy reactions other than the ones considered under the baseline scenario are assumed under the adverse scenario. As a result, no information on future policy steps can be inferred from the adverse scenario. This applies in particular to the Transmission Protection Instrument (TPI). This new instrument in the ECB’s toolkit can be activated to counter unwarranted, disorderly market dynamics that pose a serious threat to the transmission of monetary policy across the euro area.

While the calibration of the adverse scenario does not consider additional endogenous responses of monetary policy to adverse developments, it accounts for the reaction of market participants, inter alia to currently already announced monetary policy measures. Concerning, in particular, the

TPI, its mere announcement and existence would also ex ante limit the risk of unwarranted, disorderly market dynamics as well as the extent to which market rates would be affected.

17. Is climate change risk considered in the scenario?

Climate risk is not explicitly considered in the scenario at this juncture as methodologies to embed it in a stress test framework are still being developed. The EBA is currently discussing how to design common methodologies to regularly assess the resilience of the banking sector to climate shocks, in line with its founding regulation. Furthermore, the EBA, along with other ESAs, the ECB, and the ESRB, has also started the preparation of a one-off joint climate stress test across the EU financial sector in accordance with the new mandates envisaged by the Renewed Sustainable Finance Strategy published by the European Commission.

Disclosure

18. How will data and results be published?

The credibility of the EU-wide stress test rests on transparency and one of the most important aspects of this exercise is the disclosure of a large amount of comparable and consistent data across the EU. The level of transparency will be comparable to the previous exercises. The EBA will release bank-level data, aggregate reports, and interactive tools. The transparency provided through such disclosure will help market participants obtain insights into potential vulnerabilities.

Next steps

19. How will the stress test results feed into the Supervisory Review and Evaluation Process (SREP) process and how will supervisors use these results?

The results of the stress test will allow CAs to assess banks' ability to meet applicable minimum and additional own funds requirements under the common downturn scenarios and assumptions. Furthermore, the results will form a solid ground for a discussion with supervisors and individual banks, to understand relevant management actions, such as how their capital planning, including dividend distribution, may be affected by the stress and, therefore, ensure that banks will remain above the applicable capital requirements, while continuing to finance the economy.

20. What is the connection between the 2023 EU-wide stress test and the work on the future changes to the EU-wide stress test?

In parallel to the 2023 EU-wide stress test, the EBA will continue working to improve the current framework and maximise the information value of the results. In addition, and considering the experience gained during the 2023 EU-wide stress test on top-down models (i.e., net fees and commissions income), the EBA will investigate further the role of top-down elements in the EU-wide stress test.