

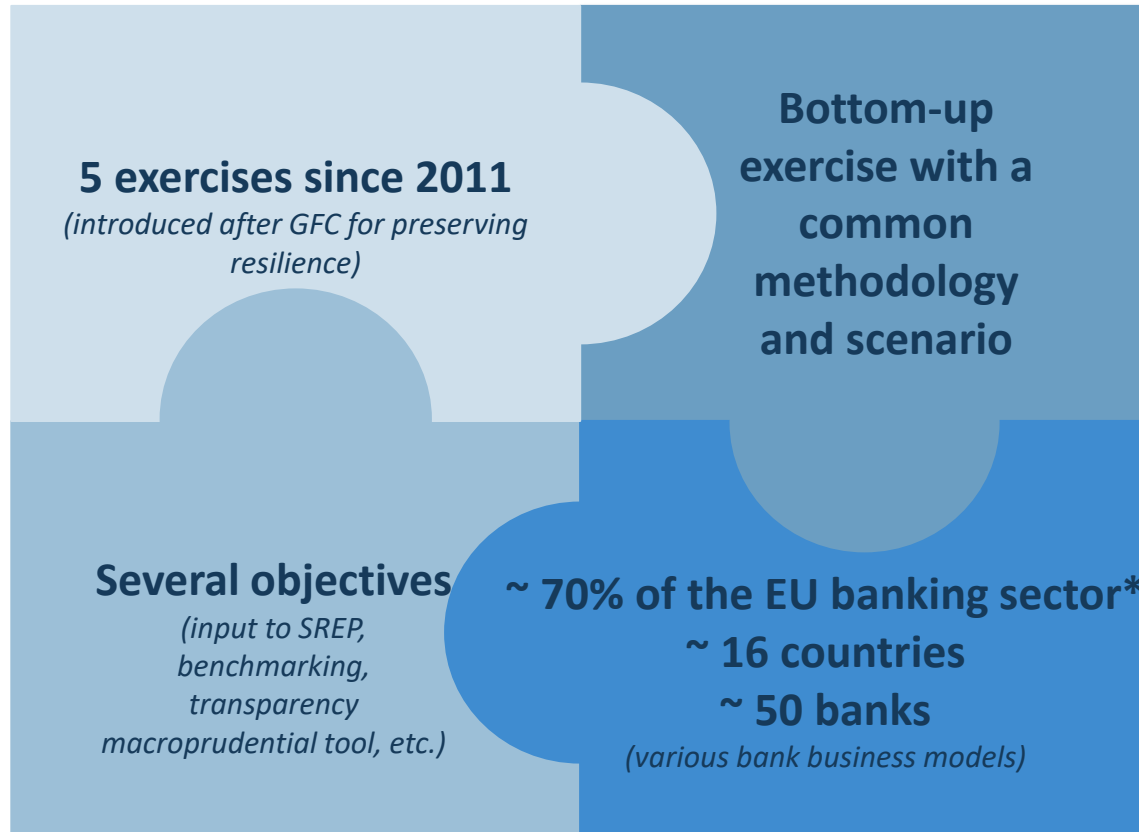


# Discussion paper on the future changes to the EU-wide stress test

EBA staff

Public hearing | 21 February 2020

# Current EU-wide stress test: A complicated jigsaw?



\* The EU and Norway.

# Rationale for changing the current framework

## ■ Why now?

- After 5 exercises a thorough reflection is needed.
- Different times require different approach (crisis vs steady state).

## ■ What worked well?

- Strengthening of banks' solvency.
- Banks' constant improvement of risk management frameworks (bottom-up approach).
- Comparable and consistent results that enable a level playing field.
- Identification of risks and ranking of banks.
- Transparency.

## ■ What could be improved?

- Focus on fewer objectives.
- Usage of results and their link to the supervisory process.
- Increase realism and ability to capture idiosyncratic risks.
- Ownership of results.
- Cost-efficiency for all parties involved.

# Objective of the EU-wide stress test and success criteria

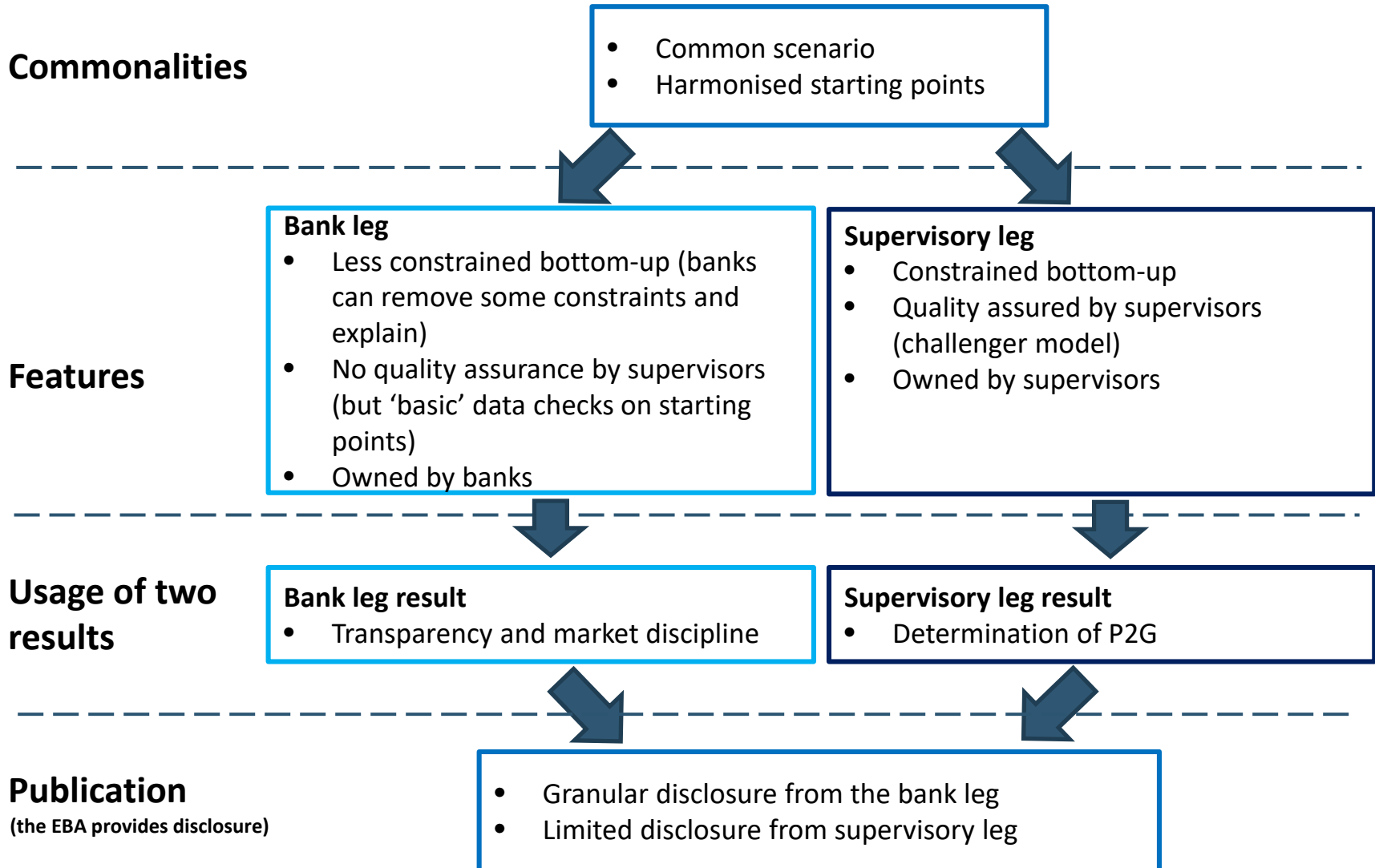
## ■ The main objective of the exercise:

- **Micro-prudential stress test for supervisory purposes.**
- **Identification of risks:**
  - ▶ **Supervisors** – concrete support to SREP; assessment of capital planning;
  - ▶ **Banks** – complement and challenge to ICAAP; improve risk management framework.
- **An important by-product: Providing information** to market participants on banks' resilience and ability to generate and distribute profits in an adverse scenario.

## ■ Criteria for assessing suitability of changes:

- Relevance – outcome as close as possible to the actual impact on capital should the adverse scenario materialise.
- Comparability – ensures a level playing field across banks.
- Transparency – disclosure to market participants, as well as clearer link of results to supervisory actions.
- Cost-efficiency – optimises supervisory and bank costs.

# Proposed new framework (current baseline option in the DP)



# Proposed new framework – variations on supervisory leg

## Commonalities

## Features

### Bank leg

- Unconstrained
- No quality
- Owned by

## Usage of two results

### Bank leg results

- Transparency

## Publication

(the EBA provides disclosure)

### Supervisory leg

- Constrained bottom-up approach:
  - Similar to the current framework, but less QA intensive.
  - Parts of it could be replaced by top-down elements (hybrid approach).
  - Possible relaxation of some constraints.
  - When forming the final outcome the competent authorities could decide to consider projections coming from the bank leg.

- Granular disclosure from the bank leg
- Limited disclosure from supervisory leg

# Proposed new framework – variations on bank leg

Common

## Bank leg

- Less constrained bottom-up approach:
  - BASELINE: The same common methodology as in the supervisory leg for obtaining the bank leg, however, banks would be allowed to decide on whether to apply the constraints prescribed in this methodology or not.
  - Alternative option 1: A common less constrained methodology for all.
  - Alternative option 2: A possible option is to allow banks to use their ICAAP models for producing the bank leg results.
  - Banks would provide reconciliation with the supervisory leg.

Feature

Two results

and publication

(the EBA provides disclosure)

discipline

- Granular disclosure

- Determination of P2G
- Limited disclosure

# Disclosure and communication of stress test results

- The EBA discloses results:
  - CET1 capital depletion derived from the supervisory leg, which is relevant for P2G.
  - CET1 capital depletion derived from the bank leg and disclosure of granular data based on common disclosure templates similar to the EBA transparency of the 2020 stress test.
  
- The disclosure of stress test results should provide enhanced clarity on the supervisory expectation for each banks' capital needs. Options for the supervisory leg are:
  - ▶ disclose the final P2G;
  - ▶ disclose ranges of P2G values;
  - ▶ disclose the CET1 capital depletion and the main adjustments applied.
  
- Banks would provide the impact of:
  - ▶ removal of methodological constraints (e.g. caps and floors);
  - ▶ dynamic vs. static balance sheet (e.g. lending increase);
  - ▶ inclusion of management actions (e.g. Additional Tier 1 coupon distribution).



## Feasibility of introducing changes to the scenarios' design

- Introducing **multiple scenarios**, options:
  - Two scenarios, where one has constant degree of severity across stress tests in different years, while the other takes into account the economic cycle when calibrating the severity.
  - Two asymmetric scenarios.
  
- Along one adverse macroeconomic scenario, introducing **sensitivity analyses** targeted at specific risks that unfolded in some of the historical episodes (e.g. liquidity risk, sovereign risk, real estate bubbles or emerging markets stress) or by taking a more forward-looking view and assessing banks' sensitivities to, for instance, climate change, business model disruptions or negative rates.
  
- Introducing **exploratory scenarios**, possibly in a independent exercise. Such scenarios would focus on potential risks with very short realisations or on risks coming from longer-term changes in the business environment:
  - ▶ Climate risk;
  - ▶ Cyber risk;
  - ▶ Liquidity risk;
  - ▶ Cross sectoral.

# Roadmap

Description		Milestones
<b>Publish the discussion paper</b>		22-Jan-2020
<b>Consultation and results</b>	Public consultation	22-Jan-2020 to 30-Apr-2020
	Public hearing on the discussion paper	21-Feb-2020
	Feedback to the industry on the comments and suggestions	mid-Jun-2020
	The final EBA decision on the changes	mid-Sep-2020
<b>Communicate changes</b>		Oct-2020
<b>Development of the new methodology</b>		2021

# Key questions\* in the discussion paper

## Outcome

- What are your views on the proposed framework (the **two leg approach with two outcomes**)?
- What are your views on the alternative proposal to publish **one single CET1 capital depletion** which would result from a dialogue/synthesis between the competent authority and banks?
- What are your views on the **consideration of the bank leg outcome** in forming the final supervisory outcome?

## Value added of the bottom-up approach

- Which **constraints** should be **relaxed to improve realism**?
- What are your views on determining the bank leg (the same methodology as in the supervisory leg but with the **possibility of relaxing constraints, a less constrained methodology** common to all banks or ICAAP)?

## Disclosure

- What are your views on the proposed granularity of disclosures (**limited disclosure on supervisory leg and transparency to the markets through the bank leg**)?
- Do you identify benefits in disclosing: the final **P2G, ranges of P2G values** or the **CET1 capital depletion** with the main adjustments applied?
- Are there any drawbacks of **publishing the banks' final P2G**?
- What are your views on a possible **disclosure of the differences** between the bank leg and the supervisory leg? What level of detail is appropriate?

## Costs, benefits and feasibility

- What are the **costs** of the new proposed framework and where do they come from? What are the **benefits**? How can the bank leg and supervisory leg be structured to mitigate costs and increase benefits?
- What would the **challenges be in explaining differences between the bank leg and the supervisory leg** (any limitations to quantifying the impact of each driver)?



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