18 March 2011

Questions and Answers on the EBA 2011 EU-wide stress test

These questions and answers are designed to assist members of the public in understanding the process of the 2011 EU-wide stress testing exercise. The objective is to explain in more detail what is happening and when.[1]

Process

***Question*: What is the objective of the EBA's stress test?**

***Answer*:** The EBA's 2011 EU-wide stress test is one of a range of supervisory tools used for assessing the prudential soundness of individual institutions as well providing information about the overall resilience of the EU banking system.

***Question:* What is the timeline for the EBA's stress test?**

***Answer*:**

- The EBA has been developing the scenarios and methodologies since late 2010 based on the lessons it learnt from its 2010 EU wide stress test
- It released to the public, its full range of documents on the scenarios and methodologies to be used on **18th March**;
- Banks, under the guidance of national supervisory authorities, have been asked to undertake the stress test in **March/April**. The date of submission by banks to the national supervisory authorities is to be determined on a country by country basis.
- Submission of the results and supporting information to the EBA on **29th April**.
- Quality assurance and peer review in **May 2011**

[1] The content and information in this note is intended for general information purposes only, and is not binding. The EBA endeavours that all the information is accurate, but does not guarantee that the information is complete and faultless. The information should not be used as a substitute for any subsequent EBA information issued regarding the EU-wide stress testing exercise.

- EBA Board of Supervisors review and agree the results **early June 2011**
- Publication of the results **mid-late June 2011**

***Question*: Will the results of the stress test be published?**

Answer: Yes, on a bank by bank basis in mid-late June.

***Question:* How will EBA check the results?**

Answer: The EBA has set aside a significant amount of time for a quality assurance review. This will involve EBA staff assisted by a number of experts checking the results to ensure the methodology has been applied correctly and checking the results against a series of benchmarks.

***Question:* Who is involved in the EBA's stress test?**

Answer: Building on the experience of two previous EU-wide stress tests undertaken by the EBA's predecessor, CEBS, the EBA is coordinating with national supervisory authorities, in cooperation with the European Systemic Risk Board (ESRB), the European Central Bank (ECB) and the European Commission a stress test on a wide sample of banks in the first half of 2011. This stress test is a part of the framework for the assessment of the resilience of the financial sector being built by the European System of Financial Supervision (ESFS) and is being carried out in parallel with stress tests undertaken by the European Insurance and Occupational Pensions Authority (EIOPA).

***Question:* Why wasn't the sample of banks released at the same time as the methodology?**

Answer: The sample is being finalised in agreement with national authorities. In any case the coverage will be similar to last year covering banking assets in Europe of over 60% and in each Member State of at least 50%.

Capital

***Question:* Is there a simple pass mark?**

Answer: Stress testing is primarily a supervisory tool and is not a simple pass/ fail test. This means that the EBA expects national supervisory authorities to assess the stress test results in the context of other supervisory assessment tools looking at the overall risk profile of institutions, including the bank's business model, quality of assets, underlying risk factors, bank's risk assessment and management systems as well as other aspects. Such ongoing supervisory assessment will also include an assessment of the level and quality of capital. Consequently, the supervisory response to the outcomes of the stress test is likely to be more complex and will take into account results of other supervisory activities than merely requesting additional capital.

These possible actions will not be restricted only to those banks who will formally fail to pass the capital benchmark set up for the purposes of the exercise.

Question: ***What capital definition is being used?***

Answer: The capital threshold will be tough and harder to pass than last year. Notably it will be focused on a definition of core tier 1 capital, which is far more restrictive than the tier 1 threshold used last year. The EBA is in the process of discussing a definition of core tier 1 capital that is based on European legislation and CEBS guidance. This will define a set of criteria which will be applied consistently for all participating banks across the EU.

Question: ***When will the definition of core tier 1 and the level be disclosed?***

Answer: The EBA members have agreed in principle to assess banks against core tier 1 capital which is a narrower definition of capital than in 2010. The EBA is in the process of agreeing the exact criteria of this core tier 1 definition, based on European legislation, to ensure consistency across the EU.

Question: ***What are the benchmarks mentioned in the methodology note?***

Answer: The ECB is developing internal benchmarks for loss rates which will be used as one of a number of tools that are helpful in understanding the results and can be used to cross reference them to assess the appropriateness of banks own measures. Banks are expected to use their own internal data and models to undertake the stress test. The benchmarks are not applied directly, they are confidential and will not be published.

Question: ***Can banks include intermediate actions (contingency plans) or change e.g. investment policies?***

Answer: No. The static balance sheet assumption must apply unless there is publicly available and legally binding reasons it should not. The methodological note provides clear rules for treatment of the exemptions from the static balance sheet assumptions. Banks may include additional information to support their stress test results but the results will be presented gross of management actions and other future actions.

Scenarios

Question: ***What scenarios is the EBA using?***

Answer: The stress test uses a set of baseline and adverse macro-economic scenarios developed in close cooperation with the EU Commission and the ESRB/ECB that cover the period of 2011 - 2012. Both macro-economic scenarios have been commonly agreed by all participating authorities. For the purposes of the trading book stress test as well as to address the sovereign risk component of the exercise, a set of stressed market parameters will be directly applied on the trading book positions.

Question: ***Are the scenarios severe?***

Answer: The EBA's adverse scenario represents a severe but plausible hypothetical event which looks at sharp movements in key macro-economic indicators such as GDP away from current expectations. The adverse macro-economic scenario, designed by the ECB, will incorporate a significant deviation from the baseline forecast, which is larger than the one assumed in last year exercise. For example, in the 2011 scenario the GDP shock for the EU has a cumulative shift from the baseline over two years of 4 percentage points. This compares to just 3 percentage points in the 2010 scenario. It will also include country-specific shocks on real estate prices, interest rates and sovereigns.

However, a stress test should be judged on a number of factors including the scenario to be assessed but also the harshness of the assumptions used and the capital threshold against which banks are assessed.

Examples of restrictive assumptions that the EBA is enforcing is the static balance sheet assumption, or the cost of funding assumption. The former restricts banks' ability to claim mitigating action. The latter will dent their P&L in significant ways not captured last year.

Question: ***Does the scenario include a sovereign default?***

Answer: The scenario includes a significant sovereign stress which is reflected in significant movements in the price of sovereign debt and the cost of raising funds. However, it does not assume that there will be a specific sovereign default.

Question: ***Does the sovereign stress extend to the banking book?***

Answer: The reality is that shocks to sovereign bonds only impact the regulatory capital position via the trading book. The regulatory treatment of holdings in the banking book means that impact of short term price shocks is limited. The feedback received by the EBA from analysts and investors is that it is far more important to provide full disclosure about all sovereign exposures, including in the banking and trading books in granular detail: this will not only allow for a split of the information on banking book exposures in the banking book between available for sale and held to maturity, but also according to maturity.

***<u>Question:</u>* Why do sovereign bond haircuts for the troubled eurozone periphery look so small?**

<u>Answer:</u> It is not correct to look at the absolute value of the haircuts compared to last year to assess the severity of the sovereign stress. The sovereign haircuts are applied on assets whose value has already been significantly revised downwards as a result of last year shocks. The comparison to CDS (which is based on a fall from the original value) is entirely misleading.

***<u>Question:</u>* Why does the scenario focus only on eurozone sovereign risk? Why does it not include recent economic news such as oil price movements or the earthquake in Japan?**

<u>Answer:</u> The EBA is focusing on the adverse scenario most relevant for the risks it is trying to address, which is a continuation of the sovereign crisis. However, the combination of the scenario and the restrictive assumptions means that the stress test gives an insight into vulnerabilities in banks generally which are likely to surface under a range of adverse scenarios. The EBA does not believe it appropriate to continuously adapt the scenario to capture the latest economic news.

***<u>Question:</u>* Is the adverse scenario consistent across countries?**

<u>Answer:</u> The scenario is based on the ECB's EU-wide model that is developed and agreed by national central banks to ensure consistency across all countries in the scenario.

***<u>Question:</u>* Is the assessment of liquidity risks included in the capital adequacy stress test?**

<u>Answer:</u> No. Liquidity risk is not specifically assessed as part of this stress testing exercise. As publicly announced by EBA in January, the liquidity profile of relevant institutions is being assessed by a specific thematic review which is for supervisory purposes. Nevertheless the 2011 EU-wide stress test does assess the evolution of the cost of funding connected to the specific financial structure of the banks in question, and in particular assesses the impact of increases in interest rates on assets and liabilities including the impact of the sovereign stress on funding costs of the institutions participating in the exercise.

***<u>Question:</u>* How is the cost of funding factored in?**

<u>Answer:</u> The impact on funding is an innovation in the 2011 exercise with a significant impact on banks P&L. It fully reflects the adverse scenario imposing a differentiated impact of the cost of funding across countries, in line with the level of sovereign stress in each country. The EBA has also provided guidelines so that banks cannot assume that they can transfer the higher cost of funding to their customers. This ensures that banks have to bear the burden of the cost of funding.

***<u>Question:</u>* Can local regulators also request local entities to perform the exercise on a solo basis?**

<u>Answer:</u> The exercise is supposed to be conducted on a bank-by-bank basis, on the highest level of consolidation of the banking group. However, national supervisory authorities may ask for additional information, if they need it for their supervisory purposes.

***<u>Question:</u>* How will the EBA factor in capital increases already announced by the banks?**

<u>Answer:</u> This is a stress test taking end 2010 as a starting point. Therefore it will be important that any changes to the capital base that occur after end 2010 are clearly disclosed even if they have already been included in banks capital base. The methodological note provides clear rules for treatment of the exemptions from the static balance sheet assumptions.

Backstops

***<u>Question:</u>* What happens if the stress tests find that banks in some Member States do not have enough capital?**

<u>Answer:</u> Together with the individual outcomes of the stress tests, the EBA will be looking at the banks' proposed mitigation action plans as well as supervisory plans set up to address deficiencies highlighted by the stress tests.

It will be imperative that where specific capital shortfalls are identified that clear backstop mechanisms are put in place.