2018 EU-wide stress test – Preliminary lessons learnt

Mario Quagliariello | Director of Economic Analysis and Statistics

EIFR The efficient stress testing: the need for a global code of practices

14 December 2018, Paris

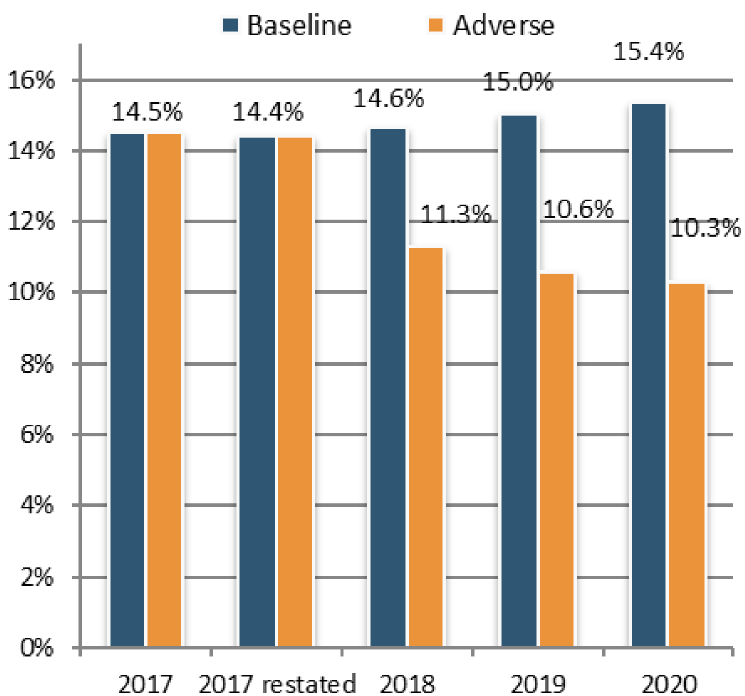
2018 EU-wide stress test: methodological key features

Approach	Bottom-up projections subject to conservative constraints; static balance sheet No pass fail exercise, input for SREP
Methodology	▪ Changes focussing on implementation of IFRS 9 (credit risk) ▪ and enhanced consistency (market risk) ▪ Specific treatment for L2/L3 assets
Scenario	▪ General macroeconomic baseline and adverse scenario provided by the ECB and the ESRB ▪ Market risk shocks
Transparency	▪ Comparable level of transparency to previous exercise, 2018 EU-wide Transparency exercise (December) will provide further data ▪ Bank-level data, aggregate reports, full data and interactive tools

2018 results – Impact on EU aggregate CET1 ratio

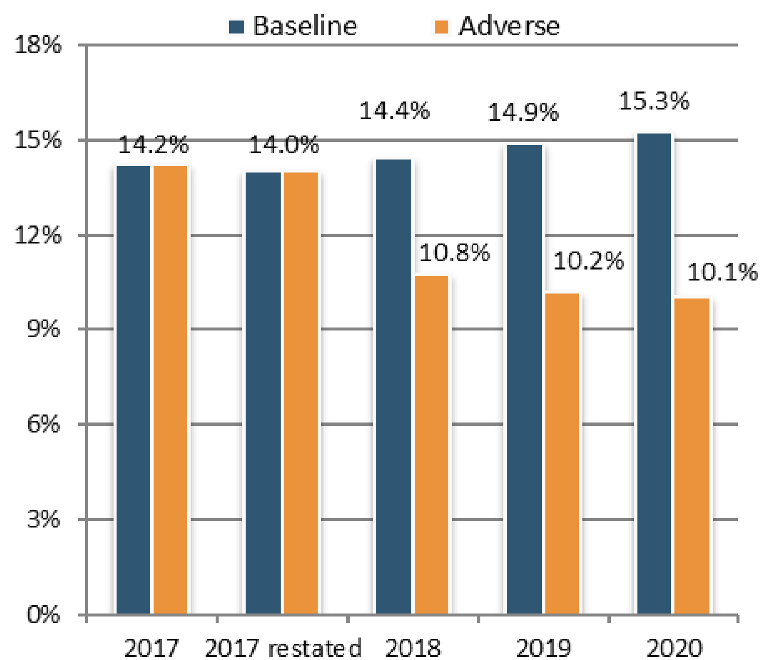
Transitional – starting point 14.5%

- IFRS 9 first implementation: -10bps
- Stress test impact: -410bps
- Capital depletion: €236bn
- Increase of total REA: €1055bn



Fully loaded – starting point 14.2%

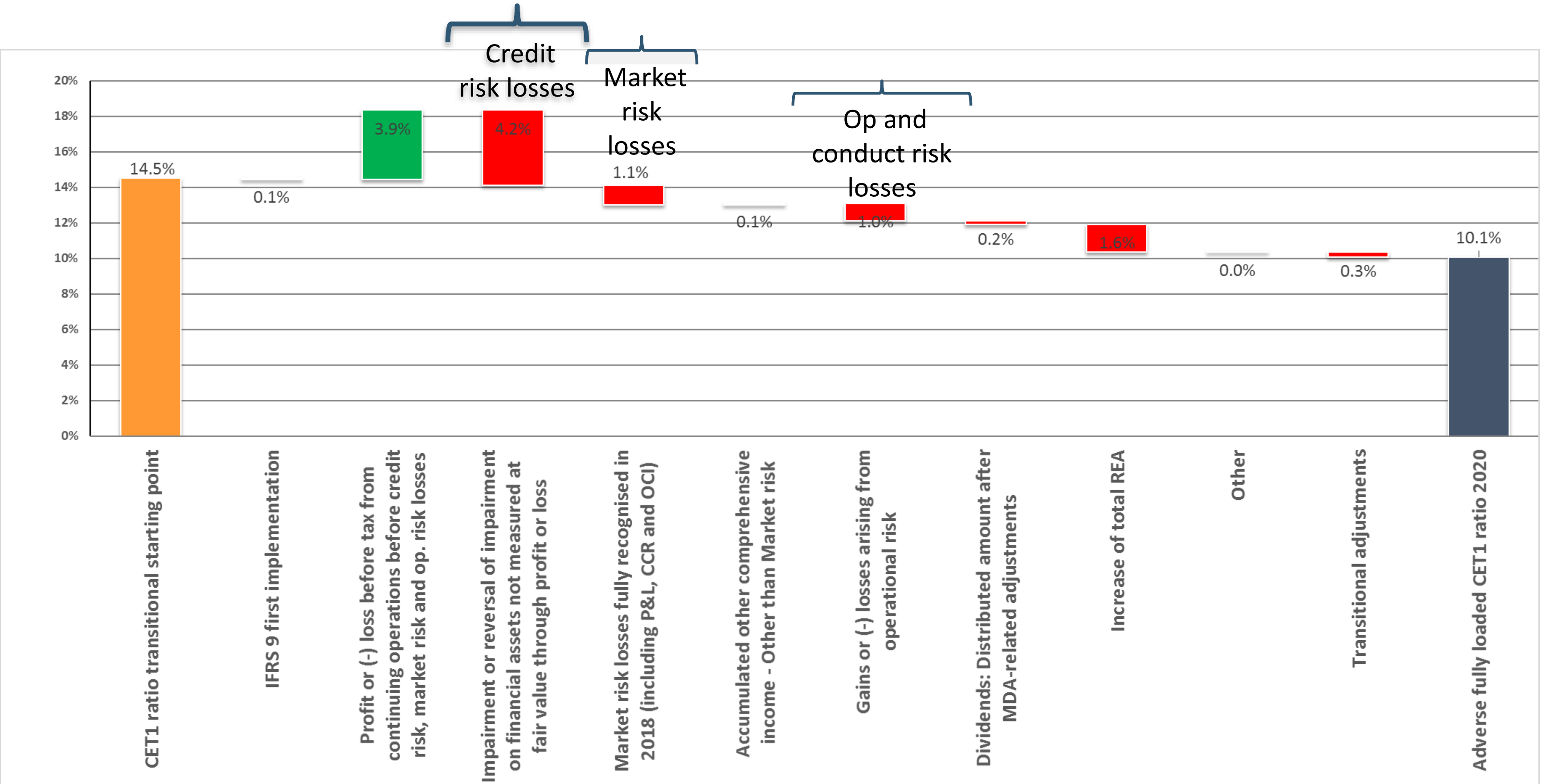
- IFRS 9 first implementation: -20bps.
- Stress test impact: -395bps
- Capital depletion of €226bn
- Increase of total REA: €1049bn



Dispersion across banks is material

- ✓ The impact on fully loaded CET1 capital ratio varies significantly across banks, from a decrease of 30 bps to 770 bps
- ✓ Large dispersion also of banks' capital position at the starting and end-point
  - CET1 ratios range from 10.8% to 41.6% on a fully loaded basis at the end of 2017 (non-restated)
  - and from 6.4% to 34% at the end-2020 adverse scenario
- ✓ All banks report minimum levels of transitional capital ratios above Pillar 1 capital requirements, with a transitional CET1 capital ratio above 4.5%, a transitional Tier 1 capital ratio above 6% and transitional total capital ratio above 8%
- ✓ 25 banks trigger MDA rules
- ✓ 4 banks with Leverage ratio below 3% in the adverse scenario

Main drivers



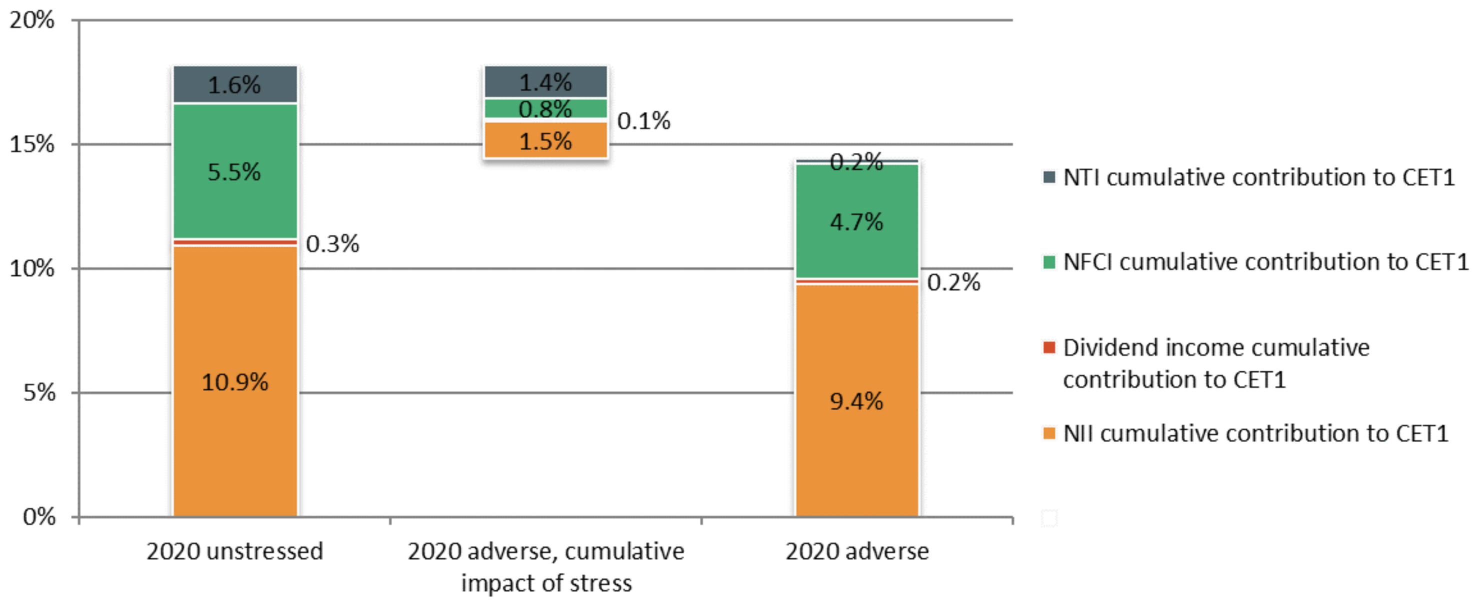
Credit losses have the highest impact: -€358bn, -425bps (-370bps in 2016)

REAs increase by 12% compared to 2017, with a negative impact on capital of 160bp (mostly IRB)

Market risk shock (including OCI): -€94bn, -110bps (-100bps in 2016)

Op. risk: -€82bn, -100bps (-110bps in 2016), mostly conduct risk, -65bps (-80bps in 2016)

Impact on profitability, aggregate EU level



Cumulative net loss before tax as of end 2020 under the adverse scenario: -€161bn, -190bps

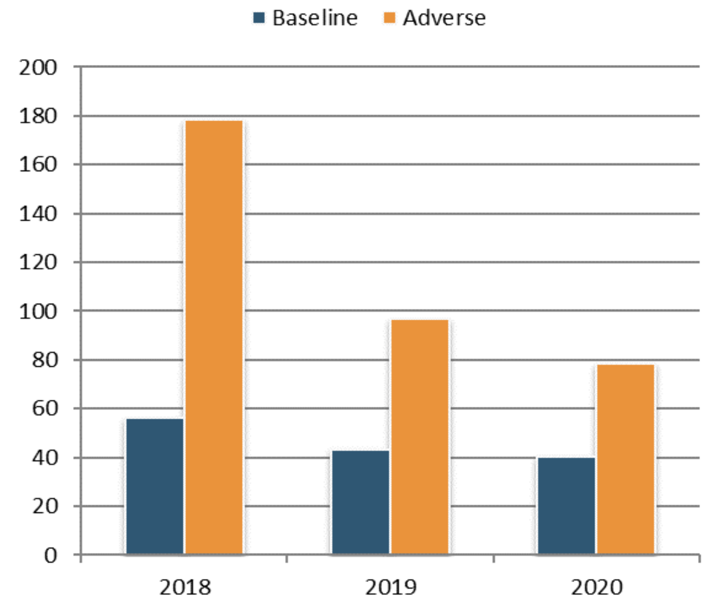
Lower contribution to capital by -150bps from NII, -80bps from NFCI, and -140bps from NTI due to the stress

2020 unstressed represents the cumulative contribution of NII, NTI, NFCI and dividend income as if the 2017 figures were kept unchanged

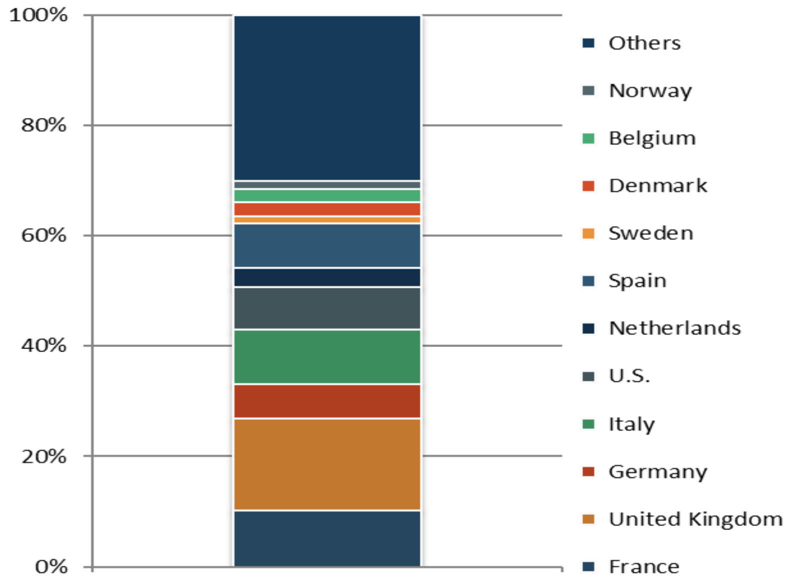
2020 adverse represents the cumulative contribution of NII, NTI, NFCI and dividend income as of end 2020 under the adverse scenario

Credit risk losses

Evolution of absolute credit losses (€ bn)



Distribution of impairments by country of the counterparty

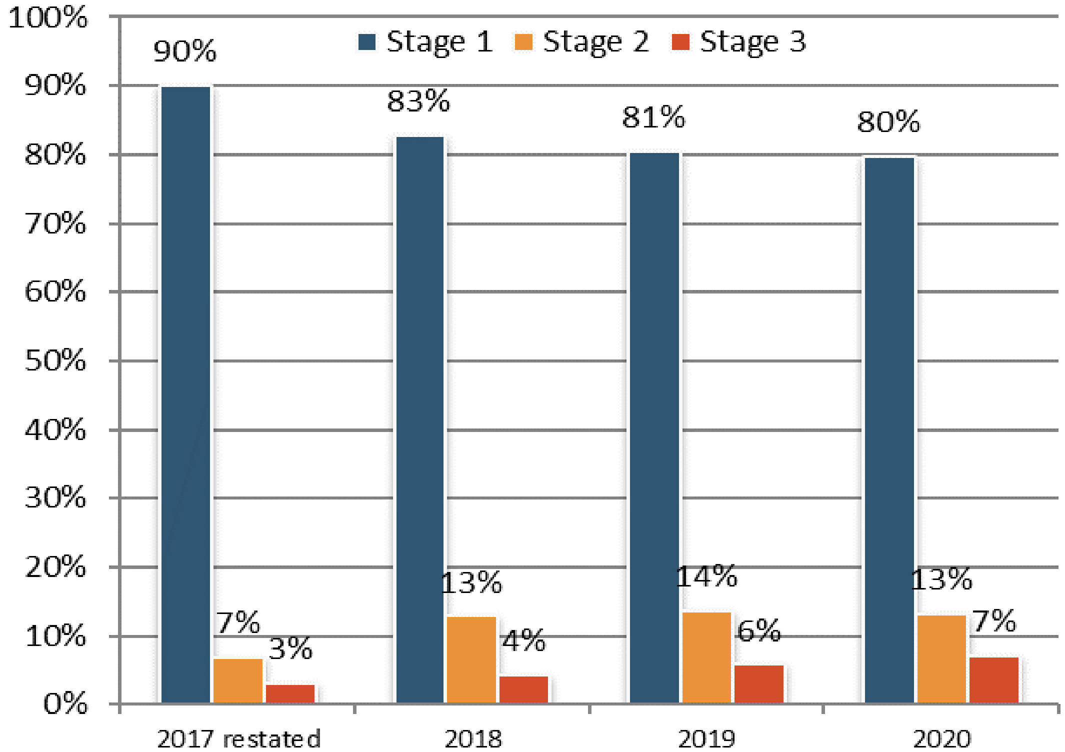


Cumulative credit risk losses over the three years of the exercise in the adverse scenario are 358bn EUR, - 425bps impact on the CET1 capital ratio

The largest impact is in the first year of the scenario, due to the perfect foresight assumption and the lifetime ECL approach for stage 2 and stage 3 exposures

Exposures towards counterparties in UK, Italy, France, US, Spain and Germany show the largest losses in absolute terms, reflecting the relevance of the volume of the exposures towards those countries. The credit risk impact also reflects the severity of the scenario in the country of the counterparties as well as the distribution of exposures across asset classes

Evolution of credit risk exposures by stages



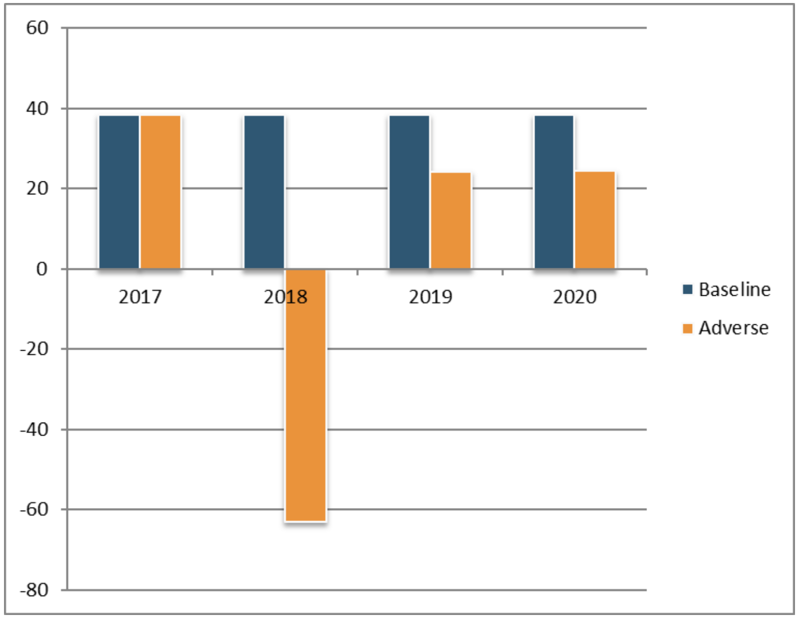
Share of stage 1 exposures decreased over the stress test horizon by 10pp, and moved to stage 2 and stage 3 exposures. Share of stage 2 and stage 3 exposures increased over the three years of the adverse scenario by 6pp and 4pp respectively

While stage 2 exposures can move to stage 1 and stage 3, exposures in stage 3 (or exposures transferred to stage 3) cannot be cured. All non-performing exposures should be classified as stage 3 exposures

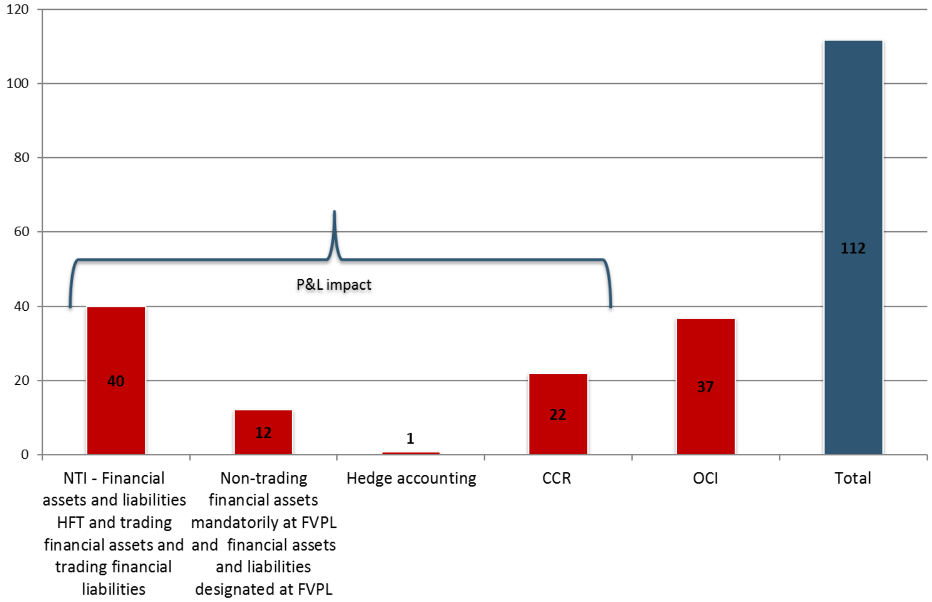
For stage 1 and stage 2 exposures, the coverage ratio stays more or less stable over the stress test horizon. For stage 3 it steadily decreases. This is driven by the high increase, in the share of stage 3 exposures (+133%) and the lower loss rates being applied to new defaults in comparison to the loss rates of the initial defaults

Market risk

Evolution of market risk P&L impact (€ bn)



Drivers of market risk losses in 2018



Instantaneous shock in the first year of the adverse scenario led to losses in 2018 followed by 2 years of reduced trading income. 2018 impact of -94 bn EUR (-110 bps on CET1 ratio), of which -63 bn EUR (-75 bps) are recognised in P&L and the rest through OCI

The losses in the first year are offset by the positive income in the next years resulting in a net cumulative loss of -14 bn EUR as of end 2020

Main drivers of MR losses in 2018: OCI (33% of total market risk impact); NTI (36% of total market risk impact) and CCR (20% of total market risk impact)

What we have learnt

- A severe exercise, with the highest impact in terms of CET1 ratio depletion (410 bps), because of the severity of the scenario and IFRS 9 implementation.
- Overall, EU banks proved to be resilient on average also thanks to strong initial capital positions and improvements in credit quality. But the stress test also confirmed that low profitability remains a challenge, especially for some banks.
- Methodology proved to be neutral to different business models. The results vary bank by bank and it is difficult to identify a clear country patterns, with better and worse performers in all countries.
- IFRS 9 and market risk add-on for L2 and L3 instruments are the main new features. L2/L3 assets mentioned as potential sources of risks – along with NPLs – by the last IMF GFSR and it was important that both aspects were taken into account in our methodology .
- The EU-wide stress test doesn't cover all possible sources of risks:
    - Disclosure of individual exposures is a necessary complement to stress test results
    - Stress test is the starting point of the wider SREP assessment

However….

- A complex exercise, involving significant resources
- Very informative on potential risks and vulnerabilities, but constraints considered as not realistic (but reality can be worse than unrealistic constraints!)
- Calibration of constraints sometimes perceived as more judgmental than model-based
- If constraints are binding most of the times, a bottom up turns into a top down
- Static balance sheet creates a lag between results and supervisory decisions
- Supervisory decisions are not disclosed

Concerns that static balance sheet and methodological caps and floors reduce the actual use for banks, supervisors and analysts…

Static balance sheet?

Banks are not deer freezing in the car headlights

… but mitigating actions can be more or less credible

Is it possible to reconcile realism, credibility and comparability?

- Disconnect between stress test results and supervisory actions is the main issue to address:

"The decoupling of stress test results and supervisory actions and the inconsistency between the transparency of the former and the opaqueness of the latter are, in my view, the main shortcoming of the EU approach compared to the US." (A. Enria, November 2018);

- Possible options for discussion:
  - Confirm the constrained bottom-up approach, but relaxing the static balance sheet assumption:
    - some modelling of the evolution of assets and liabilities in the adverse scenario,
    - allowing banks to take into account major changes in their corporate structure and adjust historical caps and floors,
    - allow bank to include some managerial actions
  - Closer integration between stress test and SREP, with banks running a bottom-up, more idiosyncratic exercise to be used for supervisory decisions and the EBA providing top-down results as a benchmark and for quality assurance
  - Disclosing SREP and P2G decisions would enhance informative value

Any fundamental change, if agreed, will require time
Feedback is very important at this stage

Thank you for your attention

EUROPEAN BANKING AUTHORITY

Floor 46, One Canada Square, London E14 5AA

Tel: +44 207 382 1776
Fax: +44 207 382 1771

E-mail: info@eba.europa.eu
http://www.eba.europa.eu