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Micro-Prudential Supervision I

Stress test in the 2014 SSM Comprehensive Assessment

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Stress Testing: Where to go from here?

Washington DC, 30 January 2015
Main features of the 2014 EBA/ECB stress-test

• Purpose:
  – Identifying trends, potential risks and vulnerabilities
  – Strengthening banks’ balance sheet
  ⇒ **Micro-prudential exercise** (which can provide useful input to macro-prudential analyses)

• Main features of the macro-financial scenario:

  1. **Abrupt reversal in risk aversion:**
     - Global increase in long-term bond yields
  2. **Further weakening of EU real economic activity:**
     - Further deterioration of credit quality in the EU
  3. **Stalling policy reform:**
     - Re-widening of EU sovereign bond spreads
  4. **Lack of necessary balance sheet repair:**
     - Funding difficulties for banks

  – **Severity** of the scenario was broadly in line with the 2014 CCAR
  – **3-year** horizon
Methodology of the 2014 EBA/ECB stress-test

• The stress-test had a **strong Bottom-Up (BU) component with Top-Down (TD) challenge**
  – BU results were provided by banks, following EBA methodological constraints
  – ECB developed a TD model, based on banks’ aggregate data, to challenge banks’ results
  – “Comply or explain” approach
  – Qualitative review of banks’ projections and explanatory notes

• **“Hard” methodological constraints** were put on banks’ projections:
  – Cap on Net Interest Income and floor on RWA
  – Floor on cost of funding and cap on pass-through to lending rates
  – Haircut on sovereign exposures
  – Transition matrix for the risk-weights of securitized products

• **Benchmarks for credit risk parameters** were shared with banks
Main results of the 2014 Comprehensive Assessment

- **Decrease of the CET1 ratio** for the median participating bank by **4.0 percentage points** (from 12.4% to 8.3%) in 2016

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<td>Median impact on CET1 ratio</td>
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*Source: ECB Aggregate Report on the Comprehensive Assessment*

- **Main drivers:**
  - Loan losses accounted for 2/3 of the adverse-baseline gap in CET1 ratios
  - Most of the remaining impact came from Net Interest Income
## Institutional challenges

- **Complex governance** due to the number of stakeholders:

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- **130 banks, 19 countries…**
Technical challenges

• Combining results from Asset Quality Review (AQR) and Stress Tests was challenging
  – No time for conducting the AQR ahead of the stress-test

• Lack of long, comparable and granular time series in Europe
  – Particularly challenging for the production of credit risk benchmarks

• Methodological issue with banks under restructuring plans
  – Adjustment to the static balance sheet assumption

• Extensive data request at a time when banks were shifting to the new Basel III regime, also for the supervisory reporting
Way forward

• Build on the **new supervisory reporting** framework

• More importance to the review of **banks’ internal stress-testing methodologies and processes**
  – Need to go beyond the validation of bank’s qualitative results

• **Additional risks**, where supervisory review could be enhanced:
  – Operational risk (in particular conduct risk)
  – Liquidity risk, as far as not captured already by the increase in cost of funding
  – Supervisory benchmarks for non-interest income (e.g. fees and commissions) should be strengthened, esp. for banks under dynamic balance sheet
Future stress-testing approaches: Bottom-Up or Top-Down?

• Bottom-Up ST: **carried out by institutions** under supervisory instructions
  – Precision
  – Flexibility
  – Information on banks’ internal stress-testing practices

• Top-Down ST: **carried out centrally** without the direct involvement of the institutions
  – Comparability
  – Scalability
  – Higher degree of supervisory control
  – Analysis of second-round effects

• **Practical constraints:**
  – Data restrictions undermine the performance of Top-Down models
  – The assessment of banks’ practices is an important input to the SREP

**In the short-term**, the current hybrid approach (“BU with TD challenge”) seems better suited. The TD approach might prevail eventually, but only **in the long-term**.
Background slides
Main results of the 2014 Comprehensive Assessment

- Capital shortfall of **€24.6 billion** across 25 participating banks (**€11.2bn** came from the stress-test)