Deloitte.

Luxembourg
Deloitte Tax & Consulting

Access previous regulatory news alerts

Deloitte regulatory news alert
EU banking stress test | EBA fires the starting gun

On Friday, the European Banking Authority (EBA) announced the main features of the 2014 EU-wide stress test it will conduct. The European Central Bank (ECB) followed up today with a note on how the stress test will fit in its comprehensive assessment. The announcements were significant in setting out the direction of travel – the ways in which the 2014 stress test will differ (or not) from the 2011 stress test and how the stress test will fit within the ECB comprehensive assessment.

As the third leg in this assessment, the stress test will follow the Asset Quality Review (AQR) and inform conclusions on any capital shortfalls that big Eurozone banks will have to fill before the Single Supervisory Mechanism (SSM) begins. Eurozone banks and supervisors have been busy preparing for the AQR. Friday's announcement signals that completing the stress test is another significant endeavour, whose deadline is fast approaching.

What did we learn from the announcement?

A number of the features of the EBA's methodology are in line with its previous exercises and to that end will not be a surprise for banks. The test will cover the trading and banking books, and banks will be required to stress credit, market and sovereign risks and their cost of funding.

In addition, some of the parameters which will be specific for the 2014 exercise are:

- Scope: The exercise will be run at the highest level of consolidation in the European Economic Area (EEA). Insurance activities will be excluded from both the balance sheet and the Profit & Loss statement.
- Time frame: Scenarios will cover the period 2014-2016.
- Minimum capital ratios (hurdle rates): 8% for the baseline scenario and 5.5% for the adverse scenario, increased from a 5% threshold for both scenarios in 2011.
- Capital: Capital adequacy will be based on Common Equity Tier 1 (CET 1). Additional Tier 1 and Tier 2 instruments may need to be reported if they can convert into CET 1 or are written down upon a trigger event and the conversion trigger is above the CET 1 ratio in the adverse scenario. The CET 1 definition will be based on the phase-in of CRD IV requirements from 2014 to 2016.
- Balance sheet assumptions: The test will assume a static balance sheet.
- Data: The test will rely on 2013 year-end figures.
- Coordination with AQR: The EBA explicitly states that AQR results should inform the starting point for the

stress test.

What are the roles of the NCAs and ECB?

The implementation of the stress test, similar to the wider comprehensive assessment exercise, will be among the first occasions where the ECB will act on its new supervisory responsibilities over Eurozone banks. The ECB, and non-Eurozone supervisors (National Competent Authorities - NCAs), will be responsible for:

- putting in place a quality assurance process;
- if necessary, developing additional and macroeconomic sensitivities and market risk shocks specific to the local contexts of the banks;
- if necessary, including additional, for example sector-specific or conduct risks, in the universe that banks need to stress; and
- exercising discretion over prudential filters for sovereign exposures. That is, while sovereign assets held in the trading book will be marked to market and sovereign assets held until maturity will be subject to shifts in risk weights embedded in the banks' internal models, the capital impact of securities held as available for sale will depend on choices made by the supervisors, as they have a discretion to filter out unrealised gains. However, such choices need to be made clear in the results.

Some practical challenges:

A number of potential challenges arise from the scope of the exercise.

First, the EBA's exercise will apply to institutions at the highest level of consolidation in the EEA. In contrast, the ECB's comprehensive assessment applies at the highest level of consolidation in the Eurozone. A small number of banks – which are head-quartered in the EU, but outside the Eurozone, and which have significant Eurozone operations – will therefore be subject to the AQR for their significant subsidiaries in the Eurozone and a stress test at group level led by their national supervisor. This creates a potential for conflict between which asset valuations (year-end or post-AQR) and which local-level approach (the national supervisor's or the ECB's) will be factored into the stress test.

Second, insurance activities are left out of scope. This is in contrast to the 2011 exercise. As a result, any income that a firm may derive from its insurance operations – and which may in practice offset the effect of a stress scenario – will not be taken into consideration.

The static balance sheet assumption means that the stress test will not take into consideration any management actions which banks have planned for the 2014-2016 period, or that they could take if needed. Whilst this approach will on the face of it enhance the comparability of results, it has the effect of disadvantaging banks that could take management action more quickly. The ECB will need to consider the additional information when it considers the stress test results in the context of its comprehensive assessment. (On a similar note, the fact that the EBA will publish the stress test results at the same time as the ECB releases the outcome of its comprehensive assessment means that it may be possible to identify the source of any capital shortfall in the ECB's assessment).

While widely reported on, the higher minimum capital ratio the EBA has set will probably not surprise banks. It is consistent with the capital benchmark the ECB is using in its AQR.

Next steps and outstanding questions:

The EBA will publish:

- Between March and April 2014: Draft stress test methodology to be circulated to banks and other market participants for feedback. Advance data collection for computing benchmarks for risk parameters;
- April 2014: The publication of final methodology, adverse scenario and templates;
- October 2014: Publication of stress test results, consistent with publication of the full outcomes of the ECB comprehensive assessment.

There are a number of questions which will need to be addressed at these subsequent stages. Aside from further details of the approach for banks to follow, of particular importance will be the degree of quality assurance that NCAs put in place. For example, will there be any attempt to control for shifts in the risk weights that banks' internal models produce, given the scope for significant variations in existing risk weights that the EBA and BCBS exercises have highlighted?

We trust this information is of assistance and remain at your disposal for any further questions.

Martin Flaunet
Partner | Luxembourg Banking Industry Leader
Deloitte Audit
Société à responsabilité limitée
560, rue de Neudorf, L-2220 Luxembourg
Grand-Duchy of Luxembourg
Tel/Direct: +352 45145 2334 | Mobile: +352 621 505 112 **mflaunet@deloitte.lu** | **www.deloitte.lu**

Marco Lichtfous
Partner | Capital Markets Services
Deloitte Tax & Consulting
Société à responsabilité limitée
560, rue de Neudorf, L-2220 Luxembourg
Grand-Duchy of Luxembourg
Tel/Direct: +352 45145 4876 | Mobile: +352 661 499 324
mlichtfous@deloitte.lu | **www.deloitte.lu**

Laurent Berliner
Partner | EMEA FSI Enterprise Risk Services Leader
Deloitte Tax & Consulting
Société à responsabilité limitée
560, rue de Neudorf, L-2220 Luxembourg
Grand-Duchy of Luxembourg
Tel/Direct: +352 45145 2328 | Mobile: +352 621 184 667
lberliner@deloitte.lu | **www.deloitte.lu**

Xavier Zaegel
Partner | Capital Markets Services
Deloitte Tax & Consulting
Société à responsabilité limitée
560, rue de Neudorf, L-2220 Luxembourg
Grand-Duchy of Luxembourg
Tel/Direct: +352 45145 2748 | Mobile: +352 621 364 628
xzaegel@deloitte.lu | **www.deloitte.lu**

Deloitte RSS feeds
Subscribe / Unsubscribe