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Deloitte Banking Alert

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EBA launches 2021 EU-wide stress test exercise

The European Banking Authority (EBA), launched the EU-wide stress test, the sixth exercise since its establishment, on 29 January 2021. Along with methodology and set of templates, EBA released the macroeconomic scenarios. After banks provide several submissions of stress test results and after these submissions are quality assured, EBA expects to publish the results of exercise by 31 July 2021.

In line with the previous exercises, no pass-fail threshold has been included as the results of the exercise are designed to serve as an input to the Supervisory Review and Evaluation Process (SREP).

Highlights from the Methodological Notes

All the banks that participate in EU-Wide stress test exercise are required to use the same macro-financial scenarios. The baseline for EU countries is based on the December 2020 projections from the national central banks. The adverse scenario for the EU-wide banking stress test reflects a subset of the main financial stability risks to which the EU banking sector is exposed, as identified by the European Systemic Risk Board (ESRB) General Board.

ESRB General Board considers that markets expect the interest rates to remain low for an extended period of time due to ongoing concerns regarding the evolution of the COVID-19 pandemic. Consequently, financial market repricing, the balance sheet vulnerabilities of EU financial institutions and unsustainable indebtedness are viewed as the major persistent risks to financial stability in the EU.

Moreover, **the 2021 adverse scenario is very severe due to the weaker macroeconomic situation in 2020** resulting from the severe pandemic-induced recession. Yet less severe than the one form the previous year (in terms of real GDP growth), as the 2021 scenario reflects the financial cycle after the pandemic crisis when the downturn had not yet occurred.

In line with the previous postponed 2020 stress test, the adverse scenario is constructed based on a “lower for longer” narrative, i.e. a recession coupled with low or negative interest rates for a prolonged period.

The most important shocks of the adverse scenario would lead to:

- a **decline in EU real GDP by 3.6%** from 2020 to 2023, due to a long-lasting recession;
- an **increase in the EU unemployment rate of 4.7 percentage points** within the same period;

- a **fall in the Harmonised Index of Consumer Prices (HICP) in the EU, with the adverse level being 1.5% lower than the baseline level in 2023**;
- Over the scenario horizon, residential real estate prices would decline by 16%, while commercial real estate prices would decline by 31%;
- Over the three year horizon, long term rates would increase by 53 bps, while the equities drop in the first year by 50% for Europe and the Developed World.

This exercise will be similar to the one announced in 2020 with the following key aspects:

- Bottom up approach and static balance sheet with strict constrains;
- Risk coverage and accounting (credit risk, market risk and operational risk reported figures under IFRS9 standards);
- Not a pass fail exercise but an input for SREP;
- Year-end 2020 figures and forecasts over a 3 year period with common scenarios use;
- Includes the transparency templates providing information on Pillar 2 Requirements (P2R) for each bank at the starting point (i.e. December 2020).

Despite similarities with previous exercise some changes are introduced and can be summarised as follows:

1. The methodology and templates include some targeted changes such as the recognition of FX effects for certain P&L items;
2. Clarified treatment of COVID-19 EBA-compliant moratoria and public guarantees;
3. Additional data collection on exposures benefiting from the moratoria and public guarantee schemes for public disclosure and quality assurance;
4. This year's methodology will reflect amendments to the capital requirements regulation that were published in the Official Journal in June 2020.

A final decision on potential changes to the EU-wide stress test framework, based on the discussion paper feedback, is expected during Q2-Q3 2021 whereas its implementation will be possible for the 2023 exercise hence not affecting the current exercise.

How can Deloitte help?

The EBA Stress Testing is a time-consuming, complex exercise that needs to be performed based on strict methodology, non-flexible templates and extended guidelines.

Deloitte is committed to provide the necessary knowledge, expertise and practical approach for successfully executing the stress test projects. Therefore, we are here to support your organization with the following services:

- **Methodological support**

  During this process we perform analysis of the current processes and models within the stress test infrastructure, identify additional areas and drivers for improvement, and assist the bank in adapting internal models to EBA requirements and optimizing the overall stress test approach.

- **Automated EBA Stress Testing tools**

  Stress test tool covers automatic data transfer, performs necessary calculations and filling in of the EBA Stress Test template. The solution enables the banks to run fast and in a standardized way several iterations, in controlled environment that ensures full trail of all data used and calculations implied.

For further questions regarding the aspects mentioned in this alert, please don't hesitate to contact us.

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