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Deloitte Banking Alert

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BoE launches 2021 solvency stress test

The Bank of England (BoE) launched the solvency stress test that will assess the major UK banks and building societies against a UK and global adverse scenario. In light of the uncertain economic outlook, and given the fact the 2020 stress test was cancelled, BoE will run the 2021 solvency stress test on a staggered timetable, but the complete bank-specific results will be published in 2021 Q4 as usual.

As with the previous exercises, the stress test is not a mechanical pass/fail regime and there is no mechanical link between the stress-test results and regulatory response. **The results of the exercise will serve to update and refine the Financial Policy Committee's (FPC's) assessment of the resilience of the UK banking system and as an input into Prudential Regulation Authority's (PRA's) transition to its standard approach to capital-setting and shareholder distributions through 2021.**

Highlights for the UK banking system stress test

According to the FPC's judgment based on a "reverse stress test" exercise conducted in August 2020, UK banks (in aggregate) have sufficient capital buffers that enable them to lend in and remain resilient to various outcomes for the UK and globally. The reverse stress test exercise calculated how severe the economic situation has to be in order to deplete regulatory capital buffers by five percentage points. **The 2021 solvency test will test banks' end-2020 balance sheets to a scenario similar to that generated by the reverse stress test.**

Although all the banks that participate in the stress test exercise are required to use the same key elements for the adverse scenario, they will most likely need to expand the provided variables for testing broader range of geographies or regions, or to estimate the evolution of additional relevant macroeconomic variable. In doing so, they will have to follow certain documentation and methodological standards.

Due to the change in the usual timetable, participating banks will not be requested to submit baseline projections and the ring-fenced subgroups of stress-test participants will not be included in the 2021 stress test, whereas the qualitative review will remain an important part of the test but with an adapted scope.

In line with the previous tests, the adverse stress scenario spans a five-year period, beginning in 2021 Q1 and extending through to 2025 Q4. However, some of the stressed metrics outlined below include the impact of the current 2020 stress.

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

- a **decline in cumulative UK GDP by 37% and 31% global GDP (based on pre-COVID baseline) from 2020 to 2022**, due to a long-lasting recession;
- an **increase in the UK unemployment rate of 8.9%** as the three-year average with its peak at 11.9% (increase of 5.6 percentage points);
- **During the five-year horizon**, **residential and commercial real estate prices** would reach a maximum **decline of 33%**.

This exercise will be similar to the one in 2019 with the following key aspects:

- The participating banks' results will be assessed on IFRS9 transitional basis;
- Not a pass fail exercise but an input for FPC and Prudential Regulation Committee;
- No mechanical link the stress-test results and setting of capital buffers;
- Year-end 2020 figures and forecasts over a 5 year period with common scenario use;
- Using perfect foresight and single scenario principles for IFRS9 provisioning calculation.

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

1. Due to the change in the timetable and uncertain economic outlook, the banks do not need to submit their baseline projections and the exercise will not include ring-fenced subgroups;
2. The qualitative review will include two components: **delivery assessment** - submission quality (focused on errors and resubmissions and explanations provided for the stress results) across the different risk areas; and **review of progress –** addressing the feedback from the 2019 qualitative review;
3. Participating banks will **submit stressed projections for impairments and credit risk-weighted assets (RWAs) by April 29th**, instead of June as before;
4. The banks **should include the effects of fiscal measures** put in place by UK and global authorities in response to the COVID pandemic in their projections (tax, spending measures, loans, guarantees, and employment support).

How can Deloitte help?

Regulatory Stress Testing are time-consuming, complex exercises that need 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 BoE requirements and optimizing the overall stress test approach.

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- **Automated Stress Testing tools**:
  Stress test tool covers automatic data transfer, performs necessary calculations and filling in of the Stress Test templates. 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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