Lessons learnt from recent stress test exercises in the euro area

International Regulators: Lessons Learned from Recent Exercises
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### The euro area stress testing framework

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- Stress testing is a **key element of the SSM supervisory toolbox**, which is used in different exercises. (Both regular and ad-hoc)
- Focus today on the **role of the stress test part of the SREP and on the EBA stress test**.
Definitions

**Bottom-up vs Top-down vs Hybrid exercises**

**Bottom-up exercise**
- Banks compute stress test results using their own internal models
- Depending on the internal model it can use granular data or be carried out based on portfolio-level / aggregated information

**Top-down exercise**
- Is carried out by the supervisor
  - Based on data provided by banks (ad-hoc or regular reporting)
  - Typically using portfolio-level / aggregated information

**Constrained bottom-up / hybrid exercise**
- Common stress scenario and methodology provided by supervisor
- Banks compute (bottom-up) stress test results using their own internal models
- Supervisor runs (top-down) stress test in order to challenge banks' internal results and to provide benchmarks for banks
- "Comply or explain" in case of material differences between bottom-up and top-down results and compliance with methodology
Stress testing in the SSM SREP

- **Key purpose of the SREP:** ensure that institutions have adequate internal processes as well as sufficient capital and liquidity to ensure a sound management and coverage of their risks.
- **Different elements** including a business model and profitability assessment and a risk-by-risk assessment considering capital and liquidity.

**Block 1:** Risk assessment system (banks’ risk levels and controls)

**Block 2:** Comprehensive review of banks’ own assessment of capital and liquidity positions (ICAAP/ILAAP)

**Block 3:** Review of banks’ own assessment of capital and liquidity needs **considering also supervisory stress test results**
EBA stress test and SREP

**EBA coordinated EU-wide stress test**

- **Goal:** Assess the resilience of financial institutions to adverse market developments, as well as contribute to the overall assessment of systemic risk in the EU financial system.

- **Comparison with the SSM SREP:**
  - It is **not limited to the euro area** supervisory authorities
  - It is coordinated by **the European Banking Authority**
  - It relies on **common EU-wide scenarios and methodology**
  - **Sample of banks** covered “Significant Institutions” in 2014 and “border-line” institutions for significance (130 institutions in total in euro area)
  - Competent authorities responsible for **quality assurance**, supported by EBA
  - Results are **published**
Link between EBA stress test and SREP

- EBA EU-wide stress test has always received strong market attention as a stand alone exercise.
- It is also linked to the SREP, as the risks and capital needs it identifies are incorporated in the overall supervisory assessment of the SSM banks.
- This approach was implemented for the first time in 2014
  - Results of the Comprehensive Assessment (comprising both an asset quality review and the EBA stress test) were incorporated as a floor in SREP decisions.
The EBA 2014 EU-wide stress test – Methodology and Quality Assurance (1)

- **Methodological guidelines** published by the EBA
- **“Hard” methodological constraints** 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
- **Centralized Q&A** process at the EU level
- **Quality Assurance manual** was communicated to banks
  - Red Amber Green (RAG) automated checks of banks’ compliance with the EBA methodology (and of the reliability of banks’ projections)
  - Description of the evidence required for granting exemptions
The **EBA 2014 EU-wide stress test – Methodology and Quality Assurance (2)**

The strong Bottom-Up (BU) component of the stress test was complemented by a Top-Down (TD) challenge:

- **BU results** are provided by banks, following EBA methodological requirements
- **Benchmarks for credit risk parameters** were shared with banks (particularly important for smaller banks)
- **Quantitative** assessment: ECB developed a TD model, based on banks’ aggregate data, to challenge banks’ results
- **Qualitative** assessment: banks’ projections and explanatory notes were reviewed by direct supervisors

"Comply or explain" approach for banks whose results deviated significantly from the TD estimates.
Lessons from the EBA 2014 EU-wide stress test

- **Data management is key**
  - Lots of time spent in sorting out data quality issues
  - External factors (new templates, tight timeline), but also possible weaknesses in data infrastructure capacities on the bank side played a role
  - Difficult to find long, comparable and granular time series for the calibration of supervisory models in Europe

- **Reliable and sufficiently granular reporting** can improve data availability and data quality in the medium / long run.
  - ITS supervisory reporting framework plays important role (and will be improved by the forthcoming EBA Transparency Exercise in 2015)

- **Dynamic balance sheet is challenging**
  - In theory, could provide more relevant results for the SREP,
  - Experience with banks under restructuring plan posed many challenges
    • Difficult to design common rules to accommodate all relevant aspects of individual restructuring plans
    • Extensive recourse to expert judgment needed
Constrained bottom-up (hybrid) approach seems to be most promising way at least in the near future

- It can most effectively leverage on banks’ models that are tailor-made to their specific risks
- It combines the advantages of the Bottom-up approach (precision, flexibility) with those of the Top-down (comparability, much stronger supervisory control)
- It overcomes some practical constraints with a full reliance on a “pure” Top-down approach
  - Data restrictions restrain the performance of a Top-down model
  - Bottom-up results are required, as the assessment of banks’ stress testing practices is important for the overall supervisory assessment.
- It requires clarity from supervisors regarding i) the description of the methodological constraints on Bottom-up results and ii) their expectations of banks’ explanations in case of divergent results
Links between the SREP and the EBA EU-wide stress test should be strengthened

- SREP and EBA EU-wide stress test can complement each other, as their results inform the supervisory assessment in both directions:
- SREP review can provide useful insights for the EBA EU-wide stress test as regards the quality of banks' internal practices and risk management
- EBA stress test provides a quantitative assessment of banks capital under stress conditions
- Complementing the EBA stress test by including additional risks that are part of SREP but have not yet been included in the EBA exercise should be considered after careful reflection of pros and cons
  - Example: conduct risk, liquidity