EU-Wide Stress Testing: Legislation, Evolution and Solutions

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HISTORY OF STRESS TESTING

The inception of EU-wide stress testing can be traced back to the aftermath of the Global Financial Crisis in 2008. In response to the crisis, European regulatory authorities recognised the need for a comprehensive assessment of the resilience of European banks. As a result, the European Banking Authority (EBA) was established in 2011, and one of its primary responsibilities became the coordination of stress tests across the European Union.

The first EU-wide stress test was conducted in 2011, marking the introduction of this crucial financial stability exercise. Since then, these stress tests have become a recurring event, typically conducted every two years. They have evolved over time to become more rigorous and comprehensive, with increasingly complex scenarios to assess the robustness of European banks in the face of adverse economic conditions. EU-wide stress testing has played a significant role in enhancing transparency, bolstering investor confidence, and promoting the stability of the European banking sector.

The results of the bi-yearly stress tests are published on a public dashboard of the EBA, detailing baseline and adverse scenarios for the Common Equity Tier (CET) 1 Ratio and Leverage Ratio. In addition to the stress test exercise results for individual financial institutions, the aggregated results for all are displayed as well (highlighted in figure 1).

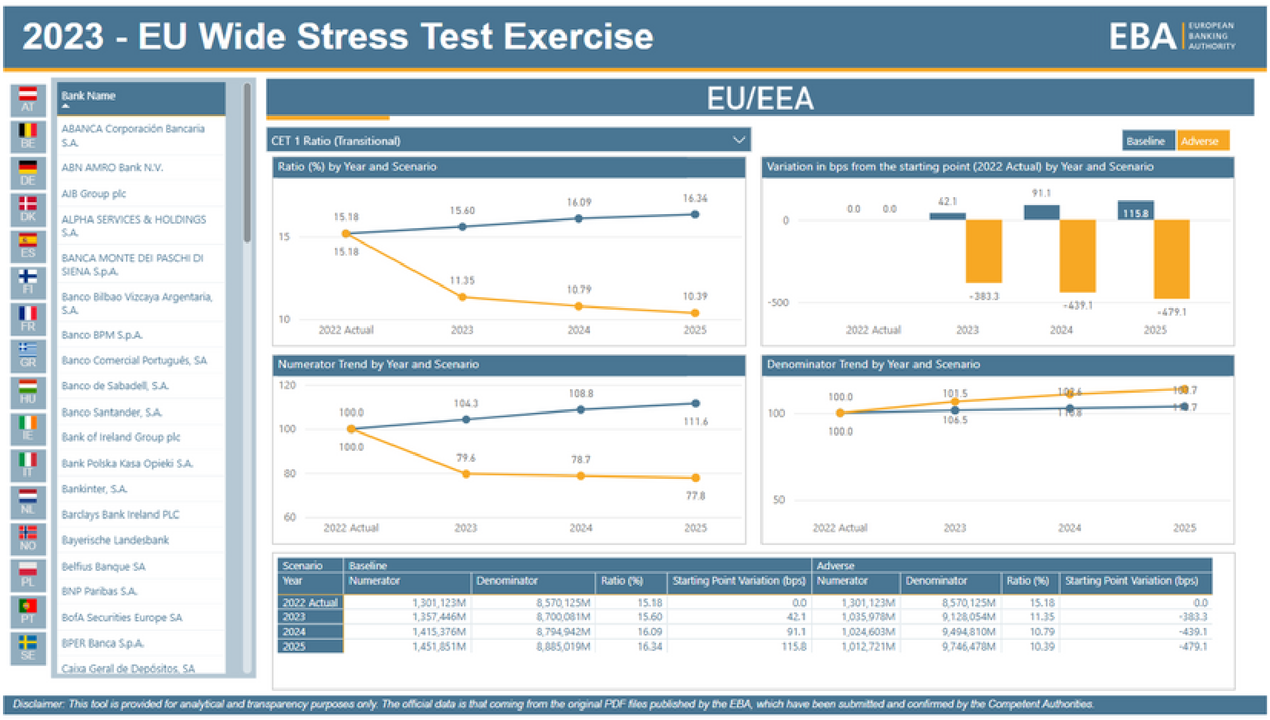

Figure 1: EBA EU wide stress test exercise dashboard, detailing EU/EEA aggregated results (European Banking Authority, (2023))

STRESS TESTING

LEGAL BASIS OF STRESS TESTING

The European Banking Authority has its own regulations that detail the technical aspects of conducting EU-wide stress tests, including the methodology, scenarios, and reporting requirements. These regulations are adopted in accordance with the broader legislative framework mentioned above. The EU-wide stress testing is tied to specific legislation within the European Union. The legal basis for these stress tests can be found in several pieces of EU legislation, including:

The Capital Requirements Regulation (CRR)

The CRR is a key piece of EU banking regulation that sets out the requirements for the capital adequacy of banks in the EU. It contains provisions related to stress testing, including the requirement for the European Banking Authority (EBA) to conduct EU-wide stress tests and publish the results. It primarily focuses on ensuring the stability and resilience of financial institutions. From a communication and transparency perspective, stress test results are often communicated to the public, shareholders, and other stakeholders, promoting transparency in the financial system. In summary, stress testing is integral to the CRR as it helps regulators, banks, and the public to understand and mitigate the potential risks that financial institutions may face during adverse economic conditions, ultimately contributing to the overall stability of the financial system.

The Capital Requirements Directive (CRD)

The CRD compliments the CRR and provides additional rules and guidelines for the supervision of banks in the EU. It includes provisions related to stress testing and specifies the authority and responsibilities of the EBA in this regard. In summary, stress testing is integral to the CRD as it serves as a multifaceted tool for risk assessment, capital adequacy evaluation, supervisory oversight, systemic risk prevention, and overall enhancement of risk governance within financial institutions. It aligns with the regulatory objective of maintaining a stable and resilient financial system.

The Bank Recovery and Resolution Directive (BRRD)

The BRRD is another important piece of EU legislation that addresses the resolution of failing banks. It includes provisions related to stress testing as part of the assessment of a bank's viability and the development of recovery plans. It outlines the primordiality of identifying vulnerabilities and weaknesses in a bank's financial position early on. Early detection is crucial for implementing corrective measures and preventing financial distress from escalating.

These pieces of legislation provide the legal framework for EU-wide stress testing, ensuring that the tests are conducted in a consistent and coordinated manner across EU member states and that the results are used to assess the capital adequacy and resilience of European banks. The EBA plays a central role in implementing these regulations and conducting the stress tests as mandated by EU law.

OBJECTIVE AND SCOPE OF STRESS TESTING

The EU-wide stress test serves as a vital tool within the regulatory arsenal employed by Competent Authorities (CAs). Its primary purpose is to gauge the robustness of EU banks when confronted with severe economic shocks, pinpoint lingering areas of uncertainty, and contribute to the decision-making process for regulatory actions. Additionally, the stress test enables CAs to ascertain whether the capital reserves accumulated by banks in recent years are adequate to absorb losses and bolster the economy during times of stress. Furthermore, this exercise promotes market transparency by disclosing consistent, detailed data at the individual bank level, illustrating the impact of common shocks on balance sheets.

The Role of the EBA (European Banking Authority)

The EU-wide stress testing process is initiated and meticulously managed by the European Banking Authority (EBA). It is carried out in close collaboration with Competent Authorities (CAs), which encompass the Single Supervisory Mechanism (SSM) for euro area banks, the European Central Bank (ECB), and the European Systemic Risk Board (ESRB). The EBA assumes the pivotal role of both coordinating the entire exercise and formulating a standardised methodology. To maintain the quality and consistency of the stress test, the EBA offers invaluable support through the provision of universal quality assurance guidelines and comprehensive EU-wide descriptive statistics relating to key risk parameters.

Timeline and outcome of Stress Testing

The stress test covers a three-year horizon, from end-2020 to end-2023. Figure 1 provides the timeline banks must comply with in regard to deliverables. The banks are required to project the impact of the scenarios on their profitability, solvency, leverage, and liquidity positions. The banks are also required to apply a static balance sheet assumption, meaning that they cannot change their business models or portfolios in response to the scenarios.

Following the commencement of the exercise, banks will assess how the adverse scenario affects their balance sheets. They will then submit multiple sets of stress test results to both Competent Authorities (CAs) and the European Banking Authority (EBA). These submissions undergo rigorous quality assurance and scrutiny by the CAs. The EBA anticipates releasing the results of the exercise by the conclusion of July 2023. The results will include bank-by-bank data on capital ratios, risk-weighted assets, losses, revenues, exposures, and sovereign holdings. The results will also include some additional information on non-performing loans (NPLs), operational risk losses, market risk losses and credit risk losses by portfolio.

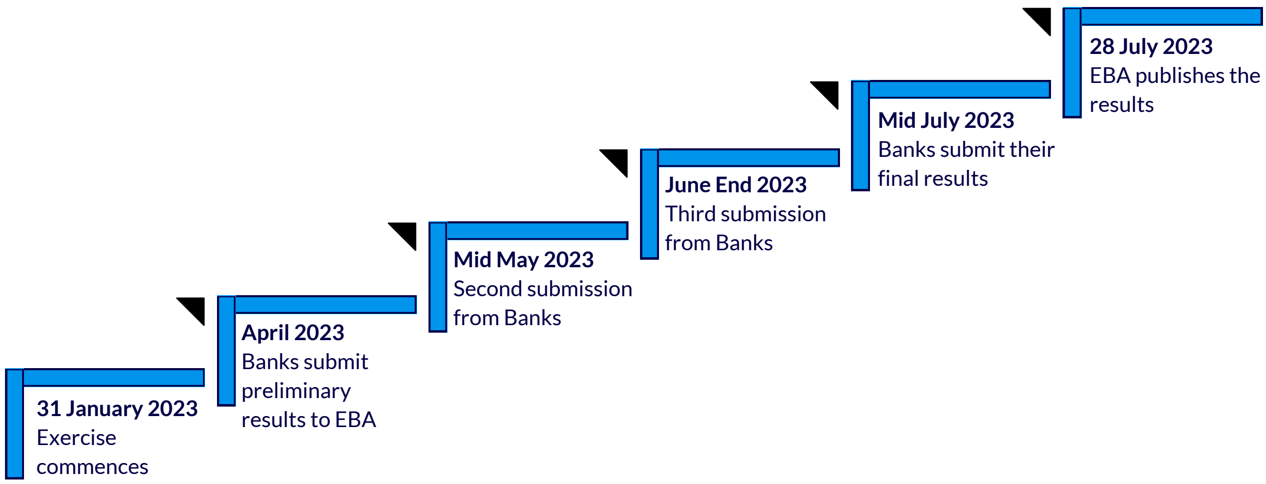

Figure 2: Timeline of stress testing regulations

Sample of Banks

The EU-wide stress test is a comprehensive assessment that covers approximately 75% of the banking sector in the euro area, as well as banks in non-euro EU Member States and Norway. This coverage is determined based on the total consolidated assets of these institutions as of the end of 2021. However, there is flexibility in representation for countries where many non-domestic EU banks have subsidiaries. To be included in the stress test sample, banks must have a minimum of EUR 30 billion in assets. Nevertheless, competent authorities have the discretion to request the inclusion of additional banks within their jurisdiction, even if they fall below this threshold. The European Banking Authority (EBA) has released the findings of the 2023 EU-wide stress test, which covered 70 banks hailing from 16 EU and EEA nations. This selection represents approximately 75% of the total assets held by banks in the EU.

Potential Challenges: Towards a solution-based approach

Although the EU-wide Stress Test Exercise for 2023 is in broad terms similar to the exercise conducted two years prior, it presents a few context-specific challenges for financial institutions. Increased interest rates and inflationary pressures have, for example, been challenging to incorporate in credit risk projections. Typically, inflation and interest rates are not explanatory variables within the existing stress testing models and therefore require additional (sensitivity) analysis to determine final loss estimates in both the baseline and adverse scenario. Moreover, the EBA has introduced a new template to allow their sectoral models to project sector-specific risk parameters. Financial institutions are now required to provide historical and projected credit risk data (i.e., exposure, loan-to-value ratio, funded collateral, and provisions, etc.) (Nelson & Toner, 2023). Making the required adjustments in existing processes and systems might cause a challenge. On an additional note, relating to the 2021 exercise, the methodology of CRR previously allowed the use of both internal and external Probability of Default (PD). The 2023 exercise, however, solely relies on external PD.

Furthermore, addressing data quality concerns requires a multifaceted approach. Establishing rigorous data governance frameworks, encompassing standardised data collection processes, validation protocols, and ongoing monitoring mechanisms, becomes indispensable. Collaborative efforts between business units and data management teams are essential to ensure the integrity and reliability of the data used in stress testing models. The scarcity of historical data beyond the last decade necessitates a forward-looking perspective. Institutions must leverage advanced analytics and modelling techniques to simulate a broader range of scenarios, bridging the gap left by the limited historical data. Incorporating macroeconomic indicators, market trends, and scenario-specific data can enhance the robustness of stress testing models, providing a more comprehensive assessment of potential risks.

In conclusion, a solution-based approach necessitates a proactive stance, combining robust data governance practices, advanced analytics, and innovative technologies to overcome the challenges posed by data quality and the temporal constraints of historical data. By embracing these strategies, financial institutions can fortify their stress testing frameworks and enhance their resilience in an ever-evolving financial landscape.

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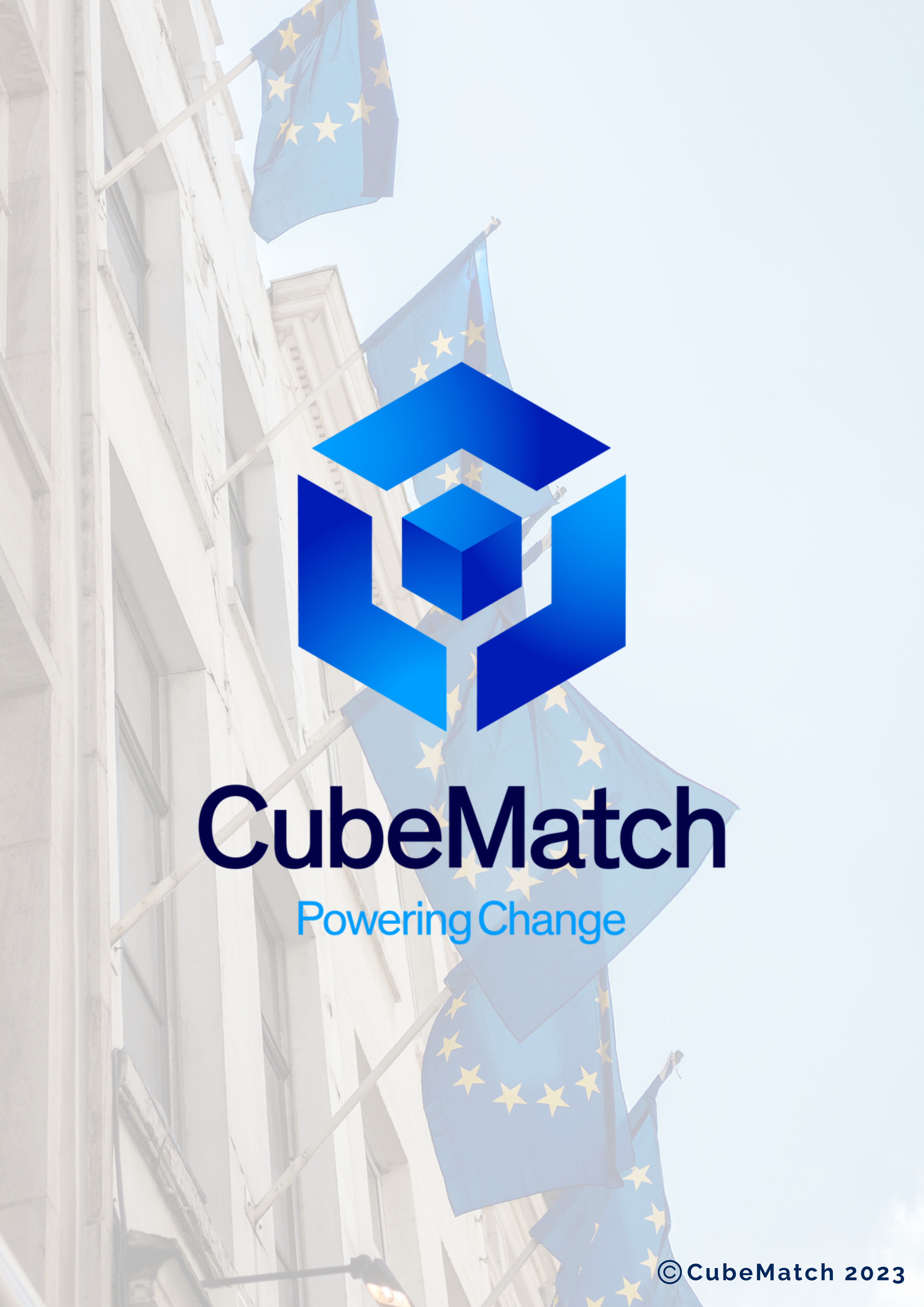

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