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EBA published results of EU-wide stress test of banks

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On Friday 29 July 2016 after the close of financial markets, the European Banking Authority ("**EBA**") published the results of its 2016 stress test exercise of European banks.

Most, but not all, banks that were included in the 2016 stress test have been given a reasonably clean bill of health despite faltering economic growth and low interest rates across the EU. This arguably demonstrates the increased resilience of the European banking sector as a whole and continuous capital raising efforts over the last several years.

The results will be reassuring for many, but those banks at the bottom of the sample pack of 51 banks will likely need to take, or continue to take, considerable steps to raise capital, increase profitability and clear non-performing loans from their balance sheets with their vulnerabilities now laid bare to both the supervisory authorities and market participants.

Scope of the stress test

The 2016 EU-wide stress test has been carried out on a sample of 51 EU and EEA based banks, a smaller sample than the 2014 exercise which covered 123 banks. Notwithstanding the narrower scope, the 2016 sample was designed to cover 70% of the banking sector in the EU. Only banks with a minimum of €30 billion in total consolidated assets were included in the stress test. This is consistent with the threshold for inclusion in the sample of banks reporting supervisory data to the EBA and the ECB-Banking Supervision definition of a significant institution.

It should be noted that the stress test did **not** include any banks from some of the more vulnerable European economies such as Greece, Cyprus and Portugal. It also did not include the many smaller banks in the EU, which leaves open how these banks would be impacted by a macroeconomic shock. Those banks not included within the scope of the 2016 stress test continue to be tested by their relevant supervisory authorities as part of the Supervisory Review and Evaluation Process ("**SREP**").

Methodology

The purpose of the 2016 stress test was to assess remaining vulnerabilities of the involved banks and to understand the impact of hypothetical adverse market dynamics on those banks. The exercise was carried out on the basis of the year-end 2015 figures assuming static balance sheets and covered the years 2016-2018. The banks were tested against an adverse scenario that included, among other things, rising long-term interest rates and risk premia, exchange rate and asset price shocks, and adverse GDP growth rates. For the first time, the stress test also included operational risk including conduct risk.

Many observers criticized the fact that the adverse scenario did not adequately reflect the real-life pressures of negative interest rates and of the further tightening of capital requirements through Basel IV. The stress-test scenario also did not specifically address the impact of UK's decision to withdraw from the EU, although it is worth noting that the GDP shock assumed in the adverse scenario of the stress test was more severe than the currently available forecasts of the impact of Brexit.

Results

The previous EBA stress tests in 2011 and 2014 contained a "pass or fail" element. In contrast, the 2016 stress test did not define a specific target capital hurdle. The stress-test results are intended to inform supervisors' ongoing review of the capital situation of banks and guide their efforts to maintain adequate capital and to repair their balance sheets as part of SREP. In addition, the EBA was provided unprecedented transparency for market participants with the publication of over 16,000 data points per bank to foster market discipline. Accordingly, whilst no specific banks can be said to have "failed" the stress test, the 2016 results do identify banks with weaknesses and by whom remedial action may need to be taken.

Overall, the stress-test results appear to confirm the success of the European banking industry's efforts to shore up its capital base in recent years. With an average CET1 ratio of 13.2% at the end of 2015, the starting point capital position for the stress test was 200 bps higher than in the 2014 stress test and 400 bps higher than in the 2011 exercise. The adverse scenario in the stress test had an aggregate impact of 380 bps on the CET1 capital ratio of the participating banks, bringing it across the sample to 9.4% at the end of 2018. The CET1 fully loaded ratio, which takes into account full implementation of CRD IV/CRR requirements, falls from 12.6% to 9.2% in the adverse scenario. The leverage ratio decreases in the adverse scenario from 5.2% to 4.2% at the end of 2018.

According to the EBA, low profitability remains an important source of concern and a challenge for the EU banking system, particularly in the context of continued low interest rates, significant impairments on account of large volumes of non-performing loans in certain jurisdictions (notably Italy) and operational risk-related losses. In addition to non-performing loans, derivative exposures have also been identified as a key issue for those banks with substantial holdings of complex assets and derivatives.

Individually, Italian Banca Monte dei Paschi di Siena had the biggest deterioration in its CET1 ratio, which fell more than 14 percentage points to a CET1 ratio of -2.23% in the adverse scenario. On the expectation of weak results in the test and a possible crisis of confidence, just before publication of the results, Banca Monte dei Paschi announced that it would transfer its entire portfolio of non-performing loans to a securitization vehicle and is also seeking a €5 billion capital increase pre-underwritten by a consortium of international banks.

All other banks managed to maintain CET1 ratios of at least 6%, with some Irish, Austrian, German, Italian, Spanish and UK banks showing CET1 ratios below average.

A summary of the aggregate and individual results of the EBA stress test can be accessed here.
More detailed information, including information on the individual banks, can be found here.

Outlook

The EBA clarified that the stress-test results would be crucial in informing the SREP conducted by supervisory authorities. SREP is the key mechanism by which supervisors review the risks that are not fully covered under so-called Pillar 1 capital requirements and decide whether capital and liquidity resources are adequate. Supervisors can use the SREP to decide that additional Pillar 2 capital is required as a new minimum.

In the upcoming weeks, supervisory authorities will discuss the stress-test results with relevant banks and the impact on institution's forward-looking capital plans and capacity to meet applicable own-funds requirements. In this context, supervisors will also assess which management actions may offset some impact of the adverse scenario. As the stress-test was based on a static balance sheet, the assessment will also take into account individual strategic and capital planning of each individual bank.

Based on such assessment, supervisory authorities may request, among others, changes to the institution's capital plan (e.g. potential restrictions on dividends) or strategy or set so-called "capital guidance" to address their concerns. Capital guidance will not be included in the calculations of maximum distributable amounts defining the bank's ability to pay dividends or interest on AT1 instruments, but supervisory authorities would expect banks to meet that guidance except when explicitly agreed, for example in severe adverse economic conditions.

To avoid such measures, some banks must continue their efforts to raise capital, increase profitability and clear non-performing loans from their balance sheets.

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