Questions & Answers

2010 EU-wide stress testing exercise

General

Q1: What does it mean to stress test a bank?

A: Stress tests are an important risk management tool that has been used for a number of years now, both by banks as part of their internal risk management practices and by supervisors to assess the resilience of banks and of financial systems in general to possible shocks.

Stress tests assess adverse and unexpected outcomes related to a variety of risks, and provide an indication of how much capital might be needed to absorb losses would the shocks that have been assumed actually occur. Usually stress tests envisage a set of hypothetical "what if" scenarios with different degrees of severity.

Stress tests do not provide forecasts of expected outcomes: the adverse scenarios are designed as "what-if" scenarios reflecting severe assumptions which are therefore not very likely to materialise.

Q2: What is the objective of the EU wide stress testing exercise? How does it differ from the exercise conducted in 2009?

A: The overall objective of the stress testing exercise is to provide policy information for assessing the resilience of the EU banking system to possible adverse economic developments and to assess the ability of banks in the exercise to absorb possible shocks on credit and market risks, including sovereign risks.

These tests have been done on a bank-by-bank basis, using banks’ specific data and supervisory information.

Compared to 2009, where the test was focused on 26 major European cross-border operating banks, the focus in 2010 has been extended to 91 banks, covering at least 50% of the national banking sector, as expressed in terms of total assets.

For the 2010 exercise it has been decided to disclose a detailed report about the assessment of the resilience of the EU banking sector, the key results of the impact of the stress scenarios on each individual bank in the exercise, as well as their sovereign exposures, with a detailed breakdown between trading and banking book exposures.
Q3: Who is responsible for the stress testing results?

A: CEBS in close cooperation with the ECB, the European Commission and participating national supervisory authorities, has developed the methodology and identified the common assumptions for the exercise.

The macro-economic and sovereign shock scenarios and parameters have been developed by the ECB. The ECB proposed the size of the haircuts to be used in the assessment of the impact of the sovereign risk on banks holdings of sovereign debt instruments, and probabilities of default and losses given default.

CEBS has subsequently been responsible for the EU-wide coordination of the exercise. Amongst others, a network of national stress testing experts has peer reviewed the results and CEBS has performed extensive cross-checks in order to ensure consistency and comparability of the results.

And lastly, it is the responsibility of each national supervisor to undertake the exercise with its banks and it is for the national supervisor to confirm the individual results of its respective bank(s).

Scenario, methods and parameters

Q4: Which stress tests have been performed?

A: In essence, we have done the following tests: first, banks need to calculate their estimated Tier 1 capital ratio under a benchmark scenario for 2010 and 2011, then the same calculations are performed under an adverse scenario and finally, within this adverse scenario, a shock on sovereign risk is considered.

Q5: What are the basic assumptions for the adverse scenario and the sovereign risk shock?

A: A specific and detailed overview of the details of the macro-economic scenarios, key common assumptions and haircuts to sovereign debt instruments used can be found in the summary report.

On aggregate, the adverse scenario assumes a 3 percentage point deviation of GDP for the EU compared to the European Commission’s forecasts cumulated over the two-year time horizon.

The sovereign risk shock in the EU represents a deterioration of market conditions of a similar magnitude as observed at the peak of the Greek crisis in early May 2010.

Q6: What is the time horizon for the stress test?

A: The exercise has been carried out on the basis of the consolidated year-end 2009 figures and the scenarios have been applied over a period of two years – 2010 and 2011. The time horizon of two years is consistent with the majority of current stress testing practices of institutions and national supervisors.
Q7: Which risks and exposures have been taken into account?

A: The stress test focuses mainly on credit and market risks, including the exposures to European sovereign debt. The focus of the stress test is on capital adequacy, liquidity risks were not directly stress tested.

With respect to exposures, the test covered banking and trading books, and addressed specifically available-for-sale equity exposures in the banking book, sovereign exposures in the trading book and securitisation exposures.

Q8: How did you stress sovereign risk?

A: The sovereign risk has been tested by applying a price-shock to the sovereign debt in the bank’s trading book by applying valuation haircuts on the trading book exposures to EU sovereign debt and by taking into account additional impairment losses on the non-sovereign exposures in the banking book - attributed to the interest rate component of the macro-economic scenario affecting the risk parameters (the so-called Probabilities of Default (PDs) and Loss Given Defaults (LGDs)).

In the design of the test we did not assume that an EU Member State would default.¹

Q9: How did you stress the sovereign risk in the banking book?

A: The test assumes a rise in the yields of government bonds that will increase the private sector’s borrowing costs, in turn leading to more defaults as firms and households may face additional difficulties in servicing their debt. This will increase the losses a bank will suffer on its exposures to the private and financial sector.

Q10: How many banks have been tested?

A: In total 91 banks have been tested in the exercise.

For the EU banking sector as a whole, the banks tested represent 65% of the EU banking sector in terms of total assets.

Q11: How were banks selected to take part?

A: The scope includes the major EU cross-border banking groups and a group of additional, mostly large credit institutions in Europe. In each EU Member State, the sample has been built by including banks, in descending order of size, so as to cover at least 50% of the national banking sector, as expressed in term of total assets.

Q12: You announced that you cover more than 50% of each of the national banking sectors in Europe, but from a number of countries no banks are on the list? How is that possible?

A: The EU banks have been tested on a group-wide basis. This means that subsidiaries and branches of a cross-border operating bank are included in the exercise as part of its consolidated group. As such, all EU Member States are covered

¹ The setting up of the European Financial Stability Facility (EFSF) and the related commitment of all participating member States provides reassurance that the default of a member State will not occur, which implies that impairment losses on sovereign exposures in the available for sale and held-to-maturity in the banking book cannot be factored into the exercise.
in the exercise and the results of an EU subsidiary of a foreign EU banking group are tested as part of a consolidated group. As a result, we have participating national supervisors from 20 EU Member States. For the remaining 7 EU Member States, where more than 50% of the local market was already covered, no further bank was added to the sample.

Some host national supervisory authorities of such subsidiaries of banks which were tested on the consolidated level may wish to separately publish the results of stress tests for the part of the banking group that they supervise. Such stress tests form a part of routine supervisory activities and do not form a part of the CEBS co-ordinated EU-wide exercise. In order not to mix the different exercises, national supervisors who wish to publish results of stress tests for the part of the banking group they supervise will disclose this information from 6th August 2010.

**Q13: How did you determine whether a bank has passed the stress test or not?**

A: For the purposes of this stress test, a threshold value for a Tier 1 capital ratio of 6% was used as a benchmark to determine a potential need for recapitalisation, whereby the regulatory minimum set by the Capital Requirement Directive (CRD) is 4%. The 6% benchmark is in line with the benchmark used in the US SCAP. 

NB: this threshold should by no means be interpreted as a regulatory minimum, or as a capital target reflecting the risk profile of the institutions determined as a result of the supervisory review process in Pillar 2 of the CRD. It is only a benchmark for this specific exercise.

**Q14: How will supervisors assess the banks that are near to this benchmark?**

A: On an ongoing basis, supervisors closely monitor the situation of the institutions under their supervision. The outcome of this stress testing exercise is to be used by the supervisors in their assessment of the vulnerabilities, risks and weaknesses of the supervised entity in question. This outcome will be included as part of the supervisory review and evaluation process, whereby the supervisor assesses all material risks of the bank in question and identifies in as far sufficient capital is available to provide for future losses.

Banks whose capital ratios decline and move towards the threshold value set up for this stress, will as we always do in such situation, be subject to closer supervisory scrutiny and more intrusive supervision. If deemed necessary, the national supervisor will ask the bank’s management to develop a plan to improve the situation, including potentially, a plan to increase capital buffers, which will be subsequently assessed by the national supervisory authority.

It should be emphasized that it is the responsibility of the national supervisory authority to require and take supervisory actions towards a bank.

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2 The US authorities referred also to a core Tier 1 ratio of 4%, but in the EU this benchmark could not be used, as there is no harmonised definition of core Tier 1 and the results would have been less comparable across countries.
On outcomes for the EU banking sector as a whole

Q15: Is the EU banking sector a sound banking sector?

A: Based on the results of the calculations, the aggregate Tier 1 ratio, used as a common measure of banks’ resilience to shocks, under the adverse scenario would decrease from 10.3% in 2009 to 9.2% by the end of 2011 (compared to the regulatory minimum of 4% and threshold of 6% set up for this exercise).

The aggregate results suggest a rather strong resilience for the EU banking system as a whole and may appear reassuring for the banks in the exercise, but it should be emphasized that this outcome is partly due to the continued reliance on government support for a number of institutions. However, given the uncertainties over the actual path of the macro-economic recovery, the result should not be seen as a reason for complacency.

Q16: Are all national banking sectors safe and sound?

A: The safety and soundness of the banks that comprise a national banking sector is the direct responsibility of the competent authorities of the EU Member States, including the Ministries of Finance, the National Central Banks, and the national supervisory authorities.

Since this question goes beyond the role and responsibilities of CEBS, we are not in a position to give such an assessment, but kindly refer to them.

Q17: How much losses have yet to be taken by banks?

A: Given the “what if” nature of stress tests and the balance between the severity of the test and the likelihood that the assumptions used will materialise, it is impossible to give a precise answer how much losses have not been taken yet. The stress test does not present an indication of the losses that have not been taken yet. It rather presents the losses which would occur if the stress test scenario indeed materialised.

Based on the aggregate results of the stress test, the downward pressure on capital ratios under the adverse scenario for the EU banking sector is mostly stemming from impairment losses (473bn € over the two-year period). Losses associated with the additional sovereign shock to the adverse scenario would reach 67bn € over the two-year period (among which 39bn € associated with valuation losses of sovereign exposures in the trading book). In total, aggregate impairment and trading losses under the adverse scenario and additional sovereign shock would amount to 566bn €.

Q18: What will happen to the government support that has already been provided to some of the banks?

A: The aggregate results illustrate the continued reliance on government support for currently 38 institutions participating in the exercise. Consequently, it seems too early to speak about a generic “forced” withdrawal. Any considerations of possible exit strategies should rather take into account detailed case-by-case analysis in order to ensure banks’ long-term viability after an exit from government support has taken place.
On individual outcomes

Q19: How many banks did not pass the test?

A: In total 7 banks did not pass the test under the adverse scenario including the sovereign risk shock, when compared to a 6% threshold Tier 1 capital ratio. Yet again, it should be noted that the threshold does not represent the regulatory minimum but was agreed as a benchmark for the purpose of this exercise.

Q20: What will happen to these banks?

A: First of all the respective national supervisors are in close contact with the banks in question to assess the results of the test and their implications, in particular any potential need for recapitalization. These banks are invited to propose a plan to address the weaknesses that have been revealed by the stress test, including a timeframe for their implementation, in agreement with their respective national supervisor.

For further information, we suggest you refer to the national supervisor.

Q21: Why did you use a Tier 1 ratio and not a core Tier 1 ratio?

A: Across the EU, we have a harmonised and precise legal definition of the components of Tier 1 capital, which is available to absorb losses and maintain a bank as a going concern. In the context of the G20 reform agenda, the Commission is in the process of harmonising the definition of the highest quality element of capital - core Tier 1. Use of such a measure at this time would not have facilitated direct comparison of results across countries. Accordingly we have used the Tier 1 ratio as a basis.

Q22: Should we keep our money at the banks that did not pass the test?

A: A bank that failed this test is by no means insolvent. All banks that are supervised in the EU need to have at least a regulatory minimum of 4% Tier 1 capital.

The outcome of the stress testing exercise should not be seen as a precise forecast of the expected future outcomes of a bank. Rather, the scenarios are designed as ‘what-if’ scenarios including plausible but extreme assumptions, which are therefore not likely to materialise. So, the results of the stress test provide information as to whether a bank would remain sufficiently capitalised in case the shock as described in the test would occur, not necessarily that this will likely occur given the current macro-economic circumstances.

Q23: Some analysts have suggested more severe outcomes than stated in this report. How is that possible?

A: The outcomes of the stress test presented by CEBS are based upon a certain ‘what if’ scenario. In our view, this scenario which has been developed in close cooperation with the ECB and with participation from the EU Commission, is a plausible but extreme one. Various analysts may have different scenarios in mind, leading to different outcomes depending on the severity of their assumptions. Also, they may adopt different capital targets and use different methodologies. Moreover, the stress
test results are based on bank’s own exposure data and supervisory information, whereas analysts are forced to rely on publicly available data only.

**On next steps**

**Q24: What will CEBS do as a next step?**

A: Part of the mandate requested of CEBS is to undertake these EU-wide stress testing exercises on a periodic basis. CEBS will continue with testing the resilience of the EU banking sector by means of periodic EU wide and thematic risk assessments and stress testing exercises.

**On comparison with the US test**

**Q25: How does this exercise compare with the US stress testing exercise which was performed nearly two years ago?**

A: Any direct comparison between the CEBS EU-wide exercise and the US stress test should be approached with caution, although there are many similarities in the two exercises: focus on the credit risk through two sets of macro-economic scenarios, two year time horizon, approximately the same coverage in terms of total assets of the system subject to the stress test, disclosure of individual bank level results.

However, there are also fundamental differences, especially on the objectives, complexity and the timing of the exercises. The objective of the CEBS exercise is to provide policy information for the assessment by individual Member States of the resilience of the EU banking sector as a whole and of the banks participating in the exercise, whereas the objective of the US test was more directly linked to determining the individual capital needs of banks. On complexity: the CEBS stress testing exercise involves more banks (91 instead of 19) and more supervisory authorities (27 instead of 3) and has been executed across 27 jurisdictions instead of 1. In addition, the number of risk factors has been different; for instance, the EU stress testing exercise also considers the effect of securitization positions and a sharp increase in sovereign risk. Also the timing is quite different. The US exercise was done in the context of a major government intervention and in order to gauge the magnitude of the needs. On the contrary, the EU exercise was carried out after some major government interventions already had taken place.
Q26: Does the adverse scenario represent a substantial stress for the banks in the sample?

A: The adverse macroeconomic scenario and the changes operated in the key micro parameters represent a substantial stress for the European banks for the following three reasons:

1. The adverse macroeconomic scenario incorporates prevailing tail risks, especially related to the sovereign debt situation; in particular, it implies that real GDP growth in the EU would be substantially lower than in currently available forecasts – on average by some 3 percentage points cumulated over 2010 and 2011 implying a recession both in 2010 and 2011. This scenario has a very low probability of occurring. Coinciding with a recession, the adverse scenario implies significant increases in interest rates, which are unlikely and are assumed only for the purpose of building a stressful scenario.

2. The severity of the adverse scenario regarding the key micro parameters arises from the combination of the increase in the haircuts for government debt in the trading book and especially in the PDs – the likelihood that a loan will not be repaid and that it will fall into default – and LGDs – the amount of losses in case of a default of a borrower:

   i. The haircuts on government debt in the trading book increase according to the introduction of sovereign risk, which is modelled as an increase in government bond spreads in line with market developments since the beginning of May 2010. For instance, the weighted average euro area five-year bond yields increase to 4.60% under the adverse scenario in 2011, compared to 2.69% at the end of 2009. Similarly, the interest rate shocks results in yields of 3.5% and of 13.9% for a five-year German and Greek government bond, respectively, at the end of 2011.

   The reference haircuts were computed from changes in the prices of 5-year sovereign bonds. The maturity of the sovereign portfolio, equal to five years at the start of the exercise, will fall to four year by the end of 2010 and to three year by the end of 2011. As sovereign default events are not envisaged, bond values converge to their par values as the time to maturity approaches zero, with all other relevant parameters being equal. Seen against this background, the haircuts are particularly significant. For instance, although the haircut of a five-year bond between December 2009 and the end of May was 12.4% for Greece, 3.1% for Portugal and 2.3% for Ireland, the test assumes haircuts of 23.1%, 14% and 12.8% for 2011. It should be highlighted that the haircuts are applied without considering any sort of hedging that the banks may have. For some non-euro area countries, the higher haircuts are driven primarily by the expected increase in long-term interest rates, with the impact of the sovereign risk shock playing a lesser role.

   The haircuts are applied to the trading book portfolios only, as no default assumption was considered, which would be required to apply haircuts to the held to maturity sovereign debt in the banking book. It should be stressed, nevertheless, that the disclosure of total exposures to sovereign debt by individual banks allows for a full assessment of their respective capital positions.
ii. The increases in PDs and LGDs are substantial and affect all portfolios in the banking book. For instance, comparing the end-2009 values with those under the adverse scenario in 2011, PDs of corporate assets double or even triple in some countries, while for the euro area as a whole they increase by over 61%.

Changes in PDs in 2011 under the adverse scenario, compared to end-2009

<table>
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<tr>
<th>Country</th>
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3. The impact of the stress-test is measured against individual banks’ capital buffers. In this respect, the EU banks (contrary to the US banks at the time of the SCAP) have already benefited from previous official public support programmes that have increased capital buffers in several national banking systems. From October 2008 to the end of May 2010, EU governments injected 236 billion euro in the capital of EU banks. In addition, there has been a substantial increase in the capital ratios by EU banks since last year as a result of retained earnings, balance sheet repair, de-leveraging, and new issuances. Accordingly, should any individual bank require additional capital as a result of the exercise, this reflects the severity of the stress assumptions under the adverse scenario.

**Application of state aid rules and backstop arrangements**

**Q27: Is a bank always subject to Commission scrutiny when it receives State support?**

A: The Commission takes many decisions on various state supports to banks (schemes and individual decisions providing guarantees on their funding or other support as well as recapitalisations). However, it should not be forgotten that banks can strengthen their capital base with the help of the State without being subject to Commission scrutiny under a restructuring plan if the amount of the aid is below 2% of their risk weighted assets.

**Q28: Why must measures granted by a Member State be compliant with State aid rules?**

A: Because State aid is under EU law in principle prohibited if it cannot be held compatible with the Internal Market. In particular, according to Article 107 (1) of the Treaty on the Functioning of the European Union (TFEU) State aid is essentially any advantage deriving for a specific undertaking or sector from State resources. Since the founding of the EU State aid rules play an important role in preserving a level playing field in the Internal Market.

For this reason, before granting any public support (capital injection or similar measures) the Commission needs to assess the compatibility of this intervention with the State aid framework. This can be done in individual cases or in the form of a scheme.

**Q29: What kind of measure (so called "backstop facilities") might a Member State use to support a bank which fails the stress test exercise?**

A: Each Member State may use all measures already approved by the European Commission (recapitalisation schemes, guarantee schemes on liabilities, impaired asset measures, etc.).

In case a Member State has not implemented any measures, or wants to introduce additional facilities (for instance, contingent capital instruments, etc.) it needs, before applying these instruments, to contact the competition services of the Commission in order to ensure that these facilities will be implemented in full compliance with State aid
rules. Further, as shown since the start of the crisis, the Commission is able to take such decisions very quickly if needed.

**Q30: How many days does the Commission need to approve the measure?**

The Commission can approve any State funding very rapidly, even overnight or at week-ends. It has done so on a number of occasions since the start of the crisis in 2007. Such approval is normally granted "temporarily", in order to safeguard financial stability.

Later, the Commission assesses more closely the nature of the aid based on the information submitted by Member States, also in order to ensure that the aided bank takes the necessary steps to restore its long-term viability without continuing State support.

**Q31: What are the rules to assess the aid granted to a bank?**

In principle, emergency recapitalisations are approved quickly on a temporary basis. In order to determine the follow up, it is important to first establish whether the bank is fundamentally sound, and only negatively affected by the turmoil on the markets, or has deeper rooted problems which require a profound restructuring of the bank.

For this distinction, the Commission uses a set of criteria, which are mainly based on four parameters: capital adequacy; size of the recapitalisation; current Credit Default Spread; current rating of the bank and its outlook.

If the result of this assessment is positive and, consequently banks are considered as "fundamentally sound" from a competition point of view, beneficiaries are required to submit only a "viability plan" in order to confirm the banks' viability without reliance on State support.

By contrast, if the bank is considered "non-fundamentally sound", it must submit a more profound "restructuring plan" in order to demonstrate the restoration of long-term viability without any State aid.

**Q32: What is the "long-term viability" under the State aid framework?**

A: Long term viability is achieved when a bank is able to cover all its cost including an appropriate return on equity, taking into account the risk profile of the bank.

**Q33: What happens if a bank fails the stress test exercise and has already received a public support?**

A: In this case, Member States are required to submit an individual notification in order to clarify the rationale and the nature of this new measure. Consequently, the Commission takes this additional measure into account in its assessment. Moreover, such second recapitalisation measures can be approved very quickly on a temporary basis, if needed.
Q34: What happens if a bank—which has already received a State support—fails the stress test exercise and the "final decision" has not been taken by the Commission?

A: In such a case of a second measure, Member States are required to submit an individual notification in order to clarify the rationale and the nature of this new measure. Such second measures can nevertheless be quickly authorised on a temporary basis. Consequently, the Commission takes this additional measure into account in its assessment before coming to a final decision on the overall aid package.

Q35: What can Member States do if they need to support their banks while they experience themselves difficulty to raise money on the markets?

A: If the results of the stress test points to necessary actions by some banks, either by injecting capital on a precautionary basis within a specified time period or by adopting the most appropriate resolution path; the main principle of interventions should remain private sector solution primacy. Such banks should ideally reinforce their capital ratio via private sources (e.g. sale of assets, rights issue).

It should be made clear that any need for recapitalisation will arise only in the event that the adverse scenario materialises so that an unfavourable result from the stress tests does not necessarily imply an immediate need for the recapitalisation of the bank concerned. However, as in the case of the US SCAP exercise\(^3\), the banks needing to augment their capital as a result of the assessment, would be required to design a detailed plan, subject to supervisory approval and take steps for its implementation within a timeframe indicated by the Member State.

Moreover, Member States are prepared for immediate actions if necessary. Overall, the majority of the Member States have backstop measures already in place (either through schemes or national decisions). Should there be a need for additional measures, Member States should do so in full compliance with the State aid rules.

Financial-market analysts are already suggesting that substantial amounts of public funding could be required, and raise issues about the capacity of some Member States to provide the necessary funds in light of recent tensions in sovereign debt markets. Against this background, the European Financial Stabilisation Mechanism (EFSM) and the European Financial Stability Facility (EFSF) have been identified as potential sources of public funding for bank support measures.

It should be noted that neither the EFSM nor the EFSF can be used directly for providing financial support to the banking sector. Such a use would be incompatible with their legal basis. On the other hand, loans provided to the government of a beneficiary Member State via either the EFSM or the EFSF could be used indirectly to provide support to the banking sector, i.e. as an element of the macroeconomic adjustment programme. There are precedents for this approach in Latvia (where part of the external financial support to Latvia - granted via the BoP facility - has been

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\(^3\) The US SCAP exercise was published in early May 2009. The banks needing to augment their capital were given one month to design a detailed plan and until early November of that year to implement it.
used to support Parex Bank) and in Greece (where EUR10 billion of the pooled loan has been earmarked to create a Financial Stability Fund for recapitalizing banks). Thus, EFSM and EFSF loans could be used to finance a government backstop mechanism in the context of the upcoming CEBS stress test if the concerned Member State was already subject to a broader macro-economic programme.