EUROPEAN CENTRAL BANK
BANKING SUPERVISION

Press release

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Stress test shows euro area banking system resilient under challenging macroeconomic scenario

- Average final CET1 ratio for 89 ECB supervised banks under three-year adverse scenario is 9.9%, down 5.2 percentage points from starting point of 15.1%
- Total includes 38 banks in EBA sample and a further 51 medium-sized ECB supervised banks
- Main drivers of capital depletion: credit risk, market risk and income-generation capacity
- For first time ECB publishes individual information for banks not part of the EBA exercise

The European Central Bank (ECB) today published the results of the 2021 stress test, which show that the euro area banking system is resilient to adverse economic developments. The Common Equity Tier 1 (CET1) capital ratio of the 89 banks in the stress test would fall by an average of 5.2 percentage points, to 9.9% from 15.1%, if they were exposed to a three-year stress period marked by challenging macroeconomic conditions. The CET1 ratio is a key measure of a bank's financial soundness.

The 89 banks covered in the report are all supervised by the ECB. They comprise 38 euro area banks that are part of the EU-wide stress test led by the European Banking Authority (EBA) and a further 51 medium-sized euro area banks. Together they represent slightly more than 75% of the total banking assets in the euro area.

Earlier today the EBA published the results of the individual banks participating in the EU-wide stress test. These results include granular data on the 38 euro area banks in that sample. For the first time, the ECB also published today selected information for the 51 medium-sized banks that are not part of the EBA sample.

The stress test is not a pass or fail exercise and no threshold is set to define the failure or success of banks for the purpose of the exercise. Instead, the findings of the stress test will be part of the ongoing supervisory dialogue.

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Banks were in better shape at the start of the exercise than they were three years ago, but capital depletion at the system level was higher. This was because the scenario was more severe than the scenario used in the 2018 stress test.

The average overall capital depletion of 5.2 percentage points can be broken down as follows. For the 38 banks tested by the EBA, the average CET1 capital ratio fell by 5 percentage points from 14.7% to stand at 9.7%.The 51 medium-sized banks tested solely by the ECB show an average capital depletion of 6.8 percentage points to 11.3%, from a starting point of 18.1%.

The main reason for this difference in capital depletion under the adverse scenario is that the medium-sized banks are more affected by lower net interest income, lower net fee and commission income and lower trading income over the three-year horizon.

The results also show that the first key driver of the capital depletion was credit risk, because the economic shock in the adverse scenario led to loan losses. Despite the overall resilience of the banking system, new challenges have emerged from the coronavirus (COVID-19) pandemic and banks need to ensure that they properly measure and manage credit risk.

For a subset of banks, the second main driver of capital depletion was market risk. Many financial products had to be fully revalued, making this the largest single driver of market risk. This affected the largest banks in particular, as they are more exposed to equity and credit spread shocks.

The third main driver was the limited ability to generate income under adverse economic conditions, as under the adverse scenario banks faced a significant decrease in their net interest income, their trading income and their net fee and commission income.

Credit risk, market risk and income generation capacity are three core issues that ECB supervisors focus on as part of their daily supervisory work.

Integration into the SREP

Supervisors take account of some qualitative outcomes from the stress test exercise, such as timeliness and accuracy of data and quality of information, when assessing banks' governance and risk management as part of the annual Supervisory Review and Evaluation Process (SREP).

Furthermore, the quantitative impact of the adverse stress test scenario is a key input for supervisors to determine the level of Pillar 2 Guidance (P2G). The P2G is a supervisory recommendation that tells banks how much capital they are expected to maintain in order to be able to withstand stressed situations.

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In line with recent orientation from the EBA, this year ECB Banking Supervision will apply a new methodology to determine the P2G. This applies a “bucketing” framework with a two-step approach. In the first step, each bank will be allocated to a P2G bucket based on its maximum fully loaded CET1 capital depletion in the stress test. In the second step, supervisors will determine the final P2G within the ranges of each bucket, and exceptionally beyond them, according to the specificities of each bank.

Therefore, while the P2G assigned to each individual bank cannot be inferred from its capital depletion in the stress test, the details provided on the new methodology should foster a better understanding of the use of the stress test results within the SREP process. In addition, the new methodology removes the P2G floors that were applied in past SREP cycles and delivers a reasonable P2G including for banks with very high capital depletion. For instance, in the current supervisory cycle no bank is expected to be assigned a P2G higher than 4.5%.

While the methodology is simple in design, it ensures a level playing field and consistency as well as allowing the specificities of each bank to be duly considered in the setting of the final P2G level.

To provide temporary capital and operational relief during the COVID-19 pandemic, the ECB committed to allowing banks to operate below the P2G and the combined buffer requirement until at least the end of 2022. This timeline is not affected by the implementation of the new P2G methodology. The ECB intends to give banks sufficient time to replenish their capital if P2G levels increase.

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Notes

- The final sample includes 51 medium-sized banks instead of the 53 announced at the launch of the exercise because two banks initially included in the sample were removed from the exercise owing to a merger in the first quarter of 2021.
- Some significant banks directly supervised by the ECB were not part of either stress test. This occurs for example if they are subsidiaries of ECB significant banks already covered in the stress test at a higher level of consolidation. Other reasons for their exclusion from the stress test might be that a bank is already included in another stress test at the same time (e.g. as part of a Comprehensive Assessment) or is in the process of merging or restructuring.
- For better comparability, all CET1 capital ratios mentioned here reflect the “fully loaded” basis, which assumes that banks already fulfil all regulatory capital requirements that are subject to transitional arrangements.

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