EUROPEAN CENTRAL BANK

BANKING SUPERVISION

FAQ

Frankfurt, 28 July 2023

Frequently asked questions on the 2023 stress test

What's the 2023 EU-wide stress test about? What is its aim?

The EU-wide stress test uses year-end data from 2022 to analyse how a bank's capital position will develop over a period of three years, to the end of 2025, under both a baseline and an adverse scenario. The exercise provides supervisors, banks and other market participants with a common analytical framework to compare and assess how resilient EU banks are to country-specific economic shocks.

The ECB will use the stress test results to assess the Pillar 2 capital needs of individual banks in the context of its Supervisory Review and Evaluation Process (SREP). The qualitative outcomes will be included in the risk governance part of the SREP, thereby influencing the determination of the Pillar 2 requirement (P2R). The quantitative results will be used as a key input for setting the Pillar 2 guidance (P2G) and, for the first time, a leverage ratio P2G.

The exercise is designed to strengthen market discipline through the disclosure of consistent and granular information at the individual bank level, illustrating how common shocks affect balance sheets. Supervisory stress testing is not a substitute for banks' internal stress tests, which they base on scenarios that are tailor-made for their specific risk profiles and vulnerabilities.

How are the samples of euro area banks in the EU-wide stress test and the parallel ECB stress test selected?

The banks taking part in the EU-wide stress test coordinated by the EBA were selected in order to cover roughly 75% of banking assets in the euro area. To be included, banks needed to have at least €30 billion in assets at the time of the sample selection. However, banks with specific business models could be excluded if the EU-wide stress test methodology was considered less suitable for assessing

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their resilience and capital adequacy. In 2023, a total of 57 euro area banks under direct ECB supervision were included in the EBA sample.

For smaller directly supervised banks that were thus outside the EBA sample, the ECB carried out its own stress test exercise in parallel. In 2023, the total number of banks participating in this stress test was 41.

Some directly supervised banks did not take part in either stress test. This occurred, for example, if they were subsidiaries or branches of banks outside the Single Supervisory Mechanism that were participating in the EU-wide exercise. Other reasons for exclusion might have been that a bank was undergoing restructuring at the time or was involved in a merger or acquisition.

What information is made available on the results?

The European Banking Authority (EBA) publishes granular results for the individual banks participating in the EU-wide exercise.

For the banks participating in the parallel SSM stress test, the ECB publishes aggregate results and selected bank-specific information. The publication approach for this sample follows the principle of proportionality, as these banks are smaller than those participating in the EU-wide exercise.

What will the ECB do with banks that have a (severe) shortfall in the adverse scenario?

The 2023 stress test is – like in previous years – not a “pass-or-fail” exercise. Therefore, there is no “shortfall” in the usual sense. Instead, the exercise provides key inputs into the SREP decisions for each bank. In practice, this means that the stress test results (in particular capital depletion levels) will be used as a starting point for setting the P2G (as foreseen in the EBA guidelines on SREP and supervisory stress testing).

In line with this approach, banks with (severe) capital depletion in the adverse scenario should generally expect a higher P2G than banks with better results.

In cases where severe capital depletion highlights particular risks in certain areas of business, the joint supervisory teams (JSTs) use this information to follow up with targeted supervisory initiatives and, where appropriate, measures to ensure that those risks are properly managed.

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How are stress test results integrated into the SREP?

Stress test results feed into the SREP both quantitatively and qualitatively.

1. Quantitative outcome

- The methodology for setting the P2G follows a two-step approach. In step 1, the bank is placed in a bucket according to its maximum Common Equity Tier 1 capital depletion in the supervisory stress test. The buckets are designed on the basis of recent supervisory experience, SSM risk tolerance and statistical analysis of stress test results. In step 2, the JSTs apply their expert judgement to adjust the P2G to the profile of each bank. The JSTs can adjust this within the ranges of the corresponding bucket and, exceptionally, beyond them.
- In the 2023 SREP, the ECB will, for the first time, apply a new methodology to determine the P2G, to address the risk of excessive leverage. This capital guidance seeks to ensure that a bank's own funds can absorb potential losses resulting from stress scenarios. To set the leverage ratio P2G, the ECB will use the leverage ratio projections in the adverse scenario of the stress test as a starting point and will follow a similar two-step process as described for the P2G above. Leverage ratio P2G is imposed only for certain institutions, for example where the projected leverage ratio falls below the overall leverage ratio requirement.

2. Qualitative outcome

- The stress test offers supervisors many insights into the risks and vulnerabilities of a bank, as well as its risk management capabilities. The JSTs consider different aspects when assessing a bank's internal governance and risk management in the context of the SREP, which eventually influence how the P2R is calculated. These aspects include, for instance, the timeliness and accuracy of data, as well as the quality of information received. Similarly, quantitative metrics derived directly from data aim to provide the JSTs with measurable criteria to assess a bank's performance by applying a scoring system based on four levels. Both the ability of banks to cope with the data requirements and their responsiveness throughout the stress test are measured. In addition, JSTs carry out a qualitative assessment of the banks' performance during the stress test quality assurance cycles.

Notes

- Bank projections in the 2023 stress test were calculated based on the accounting rules that were applicable as of 31 December 2022. As the IFRS 17 accounting standard for insurance activities only entered into force on 1 January 2023, this was not considered in the exercise. To ensure sufficient transparency, the EBA has however disclosed selected memorandum items which include the impact of IFRS 17. This should facilitate comparisons between the stress test outcome and the relevant capital ratios as of 1 January 2023. These memorandum items have however not been subject to the same thorough quality assurance as performed by competent authorities for the other published stress test data.

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