Prospects

Aperiodic – No.18/225 – 7 November 2018

The point of view

On the routinisation of stress testing in Europe

In spite of using stricter macro-financial assumptions and methodological standards, the results of the European Banking Authority's latest round of stress tests contained few surprises relative to the 2016 exercise. As the banking sector gets stronger and rids itself of its weakest links, stress tests are, in the market's eyes, looking increasingly like a routine exercise.

The stress test results published Friday 2 November have been welcomed by analysts, who judged the exercise credible due to the severity of the adverse scenario used. The median fully loaded CET1 capital ratio comes out at 10.1% in 2020 following a three-year stressed period, equating to a -395 bps impact relative to the position at end 2017. By comparison, the 2016 exercise projected a median fully loaded CET1 ratio of 9.2% under the adverse scenario, equating to a -340 bps impact. The impact of the introduction of the IFSR 9 accounting standard was very modest (20 bps).

The adverse macro-financial scenario was more severe than in 2016, notably to simulate the impact of a disorderly Brexit; however, the widening of spreads on Italian debt since September has already exceeded the stress assumptions. The adverse scenario assumed a 2.7% contraction in European GDP, a 30% drop in share prices and a 20% fall in residential property prices. The stress scenario, established at the end of 2017, assumed a 10-year Bund yield of 1.5% at end 2020, with a 250 bps spread to the Italian 10-year BTP (the latter is currently fluctuating around 300 bps). However, the level of the BTP remains below that used in the stress assumptions (currently between 3.0% and 3.5%, compared with a projected 4.0% at end 2020 under the adverse scenario).

European banks' resilience in this exercise is not a surprise, given the ongoing improvements in their solvency since the results of the previous round of tests were published. The fully loaded CET1 ratio rose from 12.6% at end 2015 to 14.2% at end 2017. Beyond the usual efforts to retain earnings, 2017 saw banks step up efforts to streamline their balance sheets by selling off non-core businesses and/or offloading non-performing loans. UniCredit, Deutsche Bank and Santander also raised €13 billion, €8 billion and €7 billion of capital in 2017 respectively.

Furthermore, the weakest banks were excluded from the sample of 48 banks. Such was the case of Monte dei Paschi, which was the subject of a precautionary recapitalisation in 2017; of Banco Popular, resolved and bought by Santander in 2017; and of Greek banks, which underwent their own stress tests at the beginning of the year. The EBA's stress tests only applied to banks with balance sheet assets in excess of €30 billion. One should also take into account parallel tests conducted by the ECB covering the remaining banks under its direct supervision, the results of which will not be disclosed.

The hierarchy of institutions has been shaken up somewhat since 2016, with UK banks Barclays and Lloyds at the bottom of the pile, suffering in particular as a result of stricter assumptions on UK exposure. However, investors are awaiting the results of the Bank of England's stress tests in December before making up their minds. The stress tests also confirmed the relative weakness of banks already identified as such: NordLB, currently seeking a buyer, and Italian banks Banco BPM and UBI. Investment banks also performed less well.

While there is no official hurdle rate for "passing" the stress tests, a CET1 ratio of 5.5% – plus the systemic buffer if applicable – is generally considered to be the minimum pass mark, as indicated by the ECB at the time of the 2016 stress tests. On this basis, only Barclays fails to measure up. However, the leverage ratio would fall below the 3% threshold for four banks (NordLB, Deutsche Bank, Banco BPM and BayernLB), and below 4% for 14 additional banks. These results will be incorporated into the supervision and prudential assessment process conducted by the ECB, which will determine Pillar 2 requirements and notify them to supervised banks in January 2019. ■

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