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The EU-wide stress tests of EBA/SSM: necessity and guarantee for a resilient banking sector?: some introductory remarks


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ABSTRACT

The purpose of a stress test for banks is straightforward: determine how much capital is required by a bank to navigate through a financial storm and continue to provide financing to the economy. The first EU-wide stress test was conducted in 2009 in the aftermath of the global financial crisis to restore confidence and has become since then an integral part of the supervisors' toolbox. It helps assess financial vulnerabilities and provide market participants with comparable information. Thanks to the interaction with the supervisor, the stress test encourages banks to think about their own vulnerabilities and their exposure to tail events. The results feed directly into capital requirement given that stress tests are the main input to determine the pillar two guidance (P2G). In the future, supervisory stress tests might move towards a more extensive use of gradual data to increase efficiency and realism. The scope of the exercise should also be enlarged to cover climate risk in addition to the more traditional financial risks.

The objective of stress test is simple in the sense that It answers very important questions: could the bank weather the storm? Would it survive or how much additional capital is required? Would it still be able to continue financing the economy? Today and more than a decade after the global financial crisis, the sovereign debt crisis in Europe and in the midst of a pandemic crisis, the role of stress tests seems obvious. However, it is only recently that stress tests started to play a central role in the world of banking supervision.

The reasons stress test is now ubiquitous is that it was used as a key tool to address financial vulnerabilities and complement standard capital ratios with a focus on tail risks during the global financial crisis. It helped assess the amount of capital required to redress the banking system and restore confidence. The disclosure of stress test results provided market participants with comparable information about the bank's balance sheets. The transparency that goes with stress test, which become a characteristic of the exercise, helped provided market participants with comparable data to correctly assess the risks of individual banks. Eventually, the transparency helped to reduce uncertainty and reassure the market in a system which is built on trust.

The first EU-wide stress test was conducted in 2009 which was coordinated by the predecessor of the EBA: The Committee of European Banking Supervisors (CEBS). Later in 2011, Stress test was a tool to guide national supervisors assess capital needs in a European perspective. In 2014 in Europe, the stress provided comparability between banks from 19 countries and helped the implantation of the transition towards the European Single Supervisory Mechanism. Currently the stress test in Europe is a regular biannual exercise. The latest results were published in July 2021.

However, as mentioned stress test is a relatively new exercise and supervisors had a steep learning curve which did not go without incidents. I think several people in this audience remember sadly the Dexia case which showed signs of significant vulnerabilities less than three months after passing the 2011 stress test. The bank had to be dismantled eventually with the intervention of taxpayer's money.

The Dexia example highlighted one of the major challenges in stress test design is that the scenario cannot cover all risks that banks might face. Of course, the lesson was learnt and now we have a better understanding on how to interpret the stress test results. The pass or fail approach is not appropriate as it gives the impression that stress tests cover all tail risks. The Dexia example, also shows why in Europe we attach a significant importance to the disclosure of detailed information to allow for market analysts to correctly understand banks vulnerabilities that are highlighted by the exercise but also to identify its blind spots.

Several years later, the main objective being unchanged which is to understand the impact of a tail risk scenario on banks, stress test serves also additional purposes now. It is the main input to determine additional capital requirement or what we call pillar two guidance (P2G). One additional positive spill-over of stress test which is not less important is that it triggers a dialogue between the banks and the supervisors. The several rounds of interactions with the banks during the stress test exercise will encourage banks to question the quality of their data, their projections and their view about their own vulnerability. The stress test will force some banks to think about situation that they have considered unlikely but are potentially a threat to their survival. Banks also conduct their own stress test, and they need to have good systems and models for it. Participation in supervisory stress test will also test the banks' ability to perform their own tail-risk projections and benchmark them against their peers.

Stress test also serves a macroprudential purpose as it measures to what extent a large economic shook could affect systemic banks together. The exercise will also provide comparable data about those large banks and supervisors analyse those data to identify macroprudential vulnerabilities.

Although stress tests coordinated by the EBA in Europe served a great purpose form reassuring the market to helping the convergence towards of a common supervision ecosystem. We are now in a different position as before. As supervisors we have invested in collecting granular information and we have now at our disposal transaction level data for derivatives, securities, loans and we might be able to use those data to change the way stress tests are conducted. The supervisors can take over part of the projections based on the acquired data and expertise and the banks can focus on elements that are specific to their business models and portfolios. We can then increase both efficiency and realism of the exercise and improve projections. There also the question of climate risk that become more urgent and we should understand its implications on our financial system.