SUPERVISORY POLICIES

EBA clarifies use of 2016 EU-wide stress test results in the SREP process

Matías Viola

The European Banking Authority (EBA) published on Friday 1st of July a clarification on the use of the 2016 EU-wide stress test results in the SREP process

Some doubts were unveiled

The results of the stress tests, involving a sample of 51 EU banks and covering 70% of the banking sector in the EU, will be published on Friday 29th July 2016. The clarification released by the EBA tries to manage expectations of banks and market participants on how the results of the stress tests will be embedded in the SREP decision as this year's stress test does not contain a pass/fail threshold. To be more precise, any capital shortfall identified over the stress test horizon could be tackled by supervisors setting a capital guidance that will sit above the binding capital (i.e.: Pillar 1 and Pillar 2) and above the combined buffer requirements therefore not having any impact on the maximum distributable amount (MDA) restrictions.

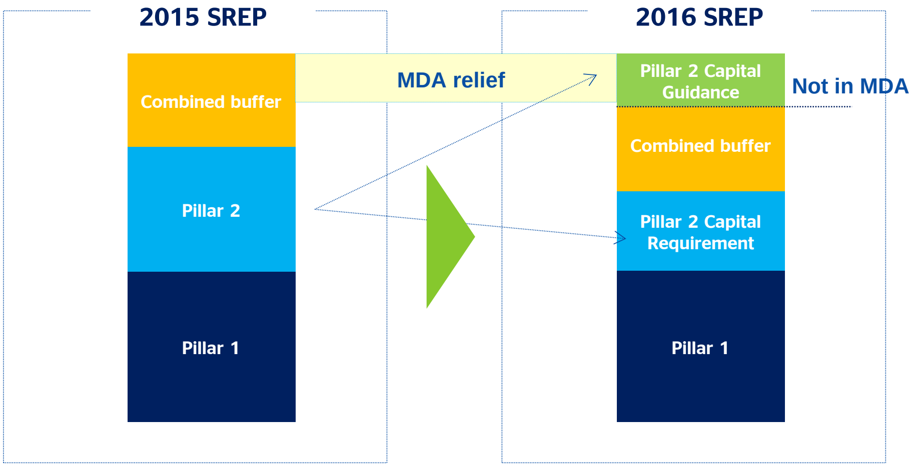
The main key points of last week´s EBA clarification are as follows: i) the results of the EU wide stress test will allow supervisors to assess banks´ ability to meet applicable minimum additional capital requirements under stressed scenarios; ii) if Competent Authorities (CA) identify capital shortfalls leading to potential breaches of applicable own funds requirements revealed by the stress tests, they can employ the capital guidance to address these concerns; iii) capital guidance should be set above the level of binding capital (minimum and additional) and the combined buffer requirements, and institutions are expected to take it into account in their risk management frameworks; iv) capital guidance does not constitute any form of binding capital requirements and is not expected to trigger the automatic restriction of the distribution and calculation of the maximum distributable amount (MDA); v) CA will monitor the capital guidance and the way it is integrated into institutions´ risk management and capital planning processes.

Practical interpretation

This approach is in line with what members of the Supervisory Board have been lately explaining in different speeches[1]. To be more precise, Ms. Lautenchläger established the following: "…*to this end, we would need, among other things, to transfer the calculation of the supervisory guidance on capital those scenarios that we, in the last year SREP exercise, took into account in the binding capital surcharge. This adjustment to the SREP concept would not change the total capital level; it would just be divided differently between requirements and guidance…*". In Figure 1 one can observe that a direct interpretation of Ms. Lautenschläger words implies a relief in the computation of the distance of the MDA for any given institution bearing in mind that, ceteris paribus, total capital requirements remain stable.

[1] Speech by Sabine Lautenschläger, member of the Executive Board of the ECB and Vice-Chair of the Supervisory Board of the Single Supervisory Mechanismo, Bundesbanksymposium "Dialogue on banking supervisión", Frankfurt am Main, 1 June 2016

Figure 1
SREP decision: capital guidance and capital requirement



Source: BBVA Research

The split of Pillar 2 into capital requirement and capital guidance raises other questions. Apparently it is not clear what the implications of breaching the capital guidance would be. According to the clarification, competent authorities would expect banks to meet the capital guidance except when explicitly agreed, for example under severe economic conditions. As such, some flexibility is to be expected but as a general rule, the capital guidance seems to be in some way mandatory.

Competent Authorities are not restricted to the measures mentioned above. As such, the results of the stress tests could not only be translated in quantitative measures but also qualitative. To be more precise, the qualitative outcomes of the stress test, including identified deficiencies in risk management and controls, hidden concentrations, previously unaccounted weaknesses in specific portfolios, or data management and reporting issues that have not been previously factored into the SREP assessment, might lead to the revisions of the conclusions on the four main SREP[2] elements.

Assessment

This degree of transparency is welcome. As such, it is important for competent authorities to explain the institutions the rationale and the general underlying principles behind the use of the stress tests results in the SREP. This year this degree of transparency is of utmost importance giving the implications of the stress test on the total capital level for institutions. However, it is still unclear how the stress test result will be translated (i.e.: in quantitative terms) into capital guidance.

[2] The main four elements of the SREP are: i) business model analysis; ii) assessment of the internal governance and institutions-wide controls; iii) assessment of the risks to capital and iv) assessment of risks to liquidity and funding

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