CEPS COMMENTARY
Thinking ahead for Europe

The ECB AQR and the EBA Stress Test: What will the numbers tell?

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With the results of its asset quality review (AQR), to be published on 26 October 2014, the European Central Bank intends to provide clarity on the shape of the 120 banks it will supervise in the eurozone, and it may request a series of follow-up actions before assuming its new set of tasks under the Single Supervisory Mechanism (SSM) Regulation in November. On the same day, the European Banking Authority (EBA) will also be publishing the results of its stress test, covering 123 banks across 22 European Economic Area (EEA) countries. For the ECB, it will be a matter of setting the standard for its future task, whereas EBA, seeks to restore the confidence it lost in the 2011 stress test and 2012 capital exercise. Both institutions will need to indicate how they will cooperate in the future in these tasks, and through enhanced disclosure, strengthen the confidence in the European banking system.

In its response to the AQR and stress test results, the ECB will need to perform a very difficult balancing act. It will need to demonstrate that it can be an impartial and unbiased supervisor, singling out possibly a series of banks that need to raise additional capital, but it will also need to avoid creating too much havoc in the markets. Hence it will set a standard for simultaneously carrying out combined monetary and supervisory policy functions under the roof of the central bank.

The ECB has been carrying out an AQR to assess the health of the eurozone banking system, prior to assuming the supervisory task under the SSM on November 4th. The AQR covers 130 banks and banking groups of the 18 different eurozone countries plus Lithuania, which will adopt the euro in 2015. It includes banks based in eurozone countries as well as banks headquartered in non-eurozone countries as well as in third countries. The AQR is not a stress test, but rather a test of the fairness and transparency of banks' balance sheets. The AQR may lead to a range of follow-up actions, possibly including requirements for changes in a bank's provisions and capital.

The EBA stress test covers a different sample of 123 banks in the 22 EEA countries (21 EU member states plus Norway), in essence the largest and/or most systemically important banks. EBA uses the same basis on which to assess the banks as does the ECB, namely a

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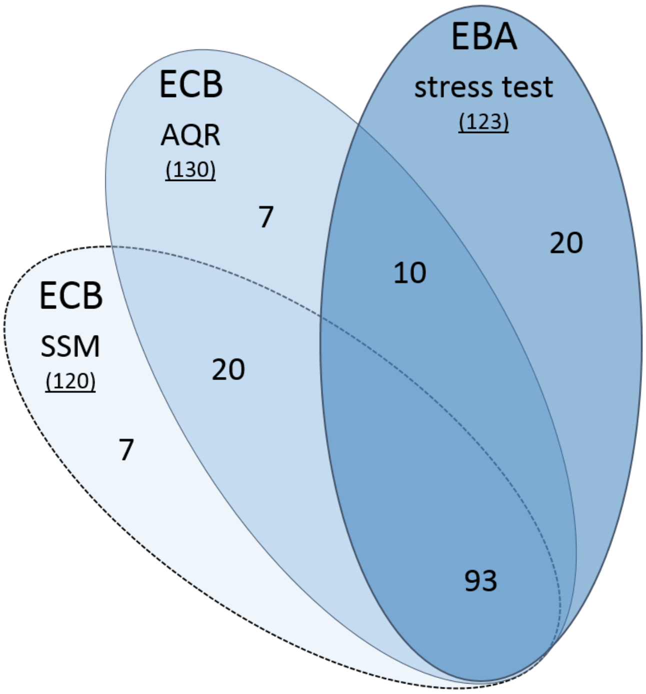
minimum of 8% Common Equity Tier 1, following the CRDIV, but it assesses the resilience of EU banks according to hypothetical baseline and adverse macroeconomic scenarios, using a common methodology developed by the EBA. Hence, the publication on the same day of an AQR by the ECB and a stress test by the EBA, on a different sample of banks and using different configurations of banking groups, may, although enhancing disclosure, also create confusion about both the sample and the data published.

Figure 1. Overlap between SSM, ECB AQR, and EBA stress test



Note: See Annex 1 for the figure with the bank names attached.

Source: Authors.

Figure 1 shows the overlap between the two exercises and the group of banks that will be directly supervised by the ECB under the SSM. The figures show that the large majority of the banks (103) are subject to both the ECB AQR and EBA stress test. Of the remaining banks, 20 banking groups located outside the euro area are subject only to the EBA stress test, and seven, mostly small banks, are only subject to the ECB AQR.

The weakness, however, is that both tests will only use one criterion to assess banks, the 8% of common equity tier 1, which is based on a risk weighting of assets and hence allows for flexibility. This risk-weighting can follow external ratings, or also internal models, which provide important scope to reduce risk-weighted assets. Moreover, some of the risk weights under the standard approach also do not reflect the underlying risks, for example zero risk weights for government debt or strongly reduced weightings for mortgage loans. In fact, the ratio of risk weighted assets to total assets has been declining over the last years, meaning that the effective levels of capital of EU banks have hardly or only moderately increased, whereas under the Tier 1 basis, they increased substantially (see Figure 2 and Figure 3).

Figure 2 Tier 1 capital ratio (% of RWAs)

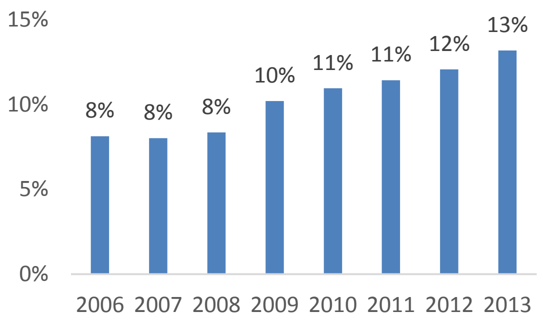
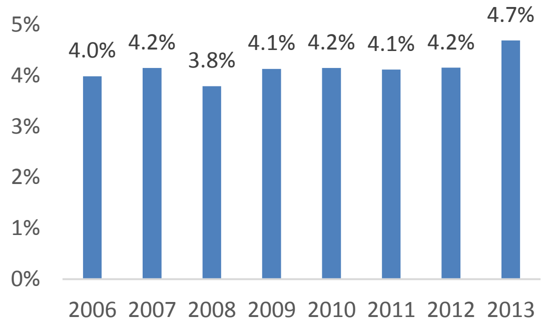


Figure 3 Tangible common equity (% of assets)



Note: The amounts expressed in the figures are median values for 147 European banking groups.

Source: Ayadi, R. and W.P. de Groen (2014), "Banking Business Models Monitor 2014: Europe", Montreal, Joint Centre for European Policy Studies (CEPS) and International Observatory on Financial Service Cooperatives (IOFSC) publication.

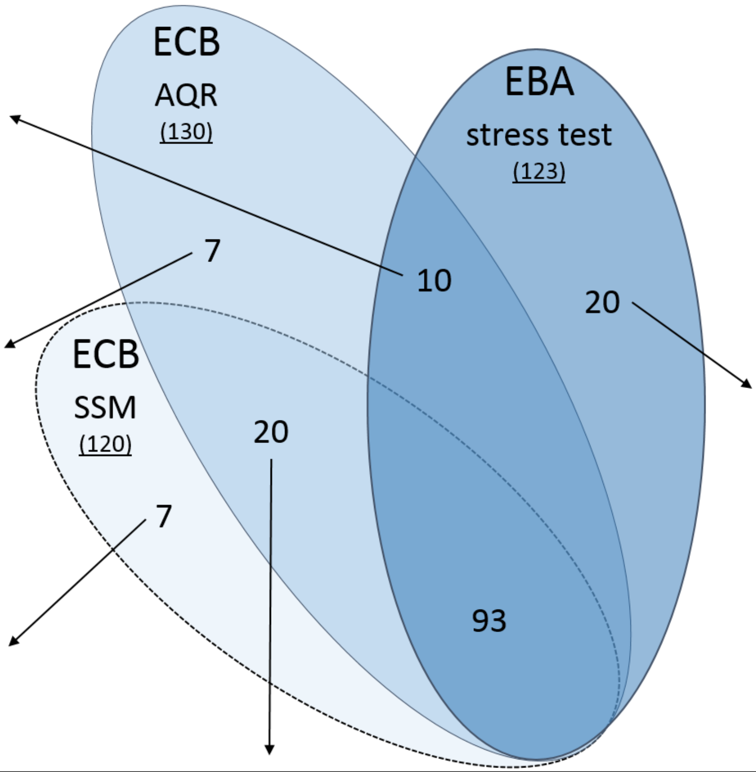
The question is for both organisations, the ECB and the EBA, what picture will they give of the European banking system, and how will markets respond. The challenge for the markets will be not to confuse the different numbers, the objectives pursued and organisations involved.

Annex 1. Overlap between SSM, ECB AQR, and the EBA stress test with bank names

Subject to ECB AQR and EBA stress test but not subject to direct supervision
- IKB Deutsche Industriebank (DE)
- KfW IPEX-Bank (DE)
- Wüstenrot Bank Pfandbriefbank (DE)
- Wüstenrot Bausparkasse (DE)
- NCG Banco (ES)
- Banque PSA Finance (FR)
- RCI Banque (FR)
- Banca Piccolo Credito Valtellinese (IT)
- Credito Emiliano (IT)
- SID - Slovenska izvozna in razvojna banka (SI)

Subject to ECB AQR but not directly supervised by ECB
- AS DNB Pank (EE)
- Banque Centrale de Compensation (LCH Clearnet) (FR)
- Merrill Lynch International Bank Limited (IE)
- AS SEB Bankas (LT)
- Swedbank (LT)
- AB DNB bankas (LT)
- Clearstream Banking (LU)

Directly supervised by ECB but not in assessments
- Sberbank Europe (AT)
- VTB Bank (AT)
- Banque Degroof (BE)
- Banesco Holding Hispania (Parent company NCG Banco) (ES)
- Barclays (IT)
- Novo Banco (former Espírito Santo) (PT)
- Unicredit Banka Slovenija (SI)



Banks subject to EBA stress test only
- Danske Bank (DK)
- Jyske Bank (DK)
- Nykredit (DK)
- Sydbank (DK)
- OTP Bank NYRT (HU)
- DNB Bank (NO)
- ALIOR BANK (PL)
- Bank Handlowy w Warszawie (PL)
- Bank BPH (PL)
- Bank Ochrony Środowiska (PL)
- GETIN NOBLE BANK (PL)
- PKO Bank Polski (PL)
- Nordea (SE)
- Skandinaviska Enskilda Banken – SEB (SE)
- Svenska Handelsbanken (SE)
- Swedbank (SE)
- Barclays (UK)
- HSBC Holdings PLC (UK)
- Lloyds Banking Group (UK)
- Royal Bank of Scotland (UK)

Subject to ECB AQR and subject to direct supervision by ECB

Subsidiaries of Euro-area banks (4)
- Deutsche Bank (MT)
- Slovenská sporiteľňa (SK)
- Tatra banka (SK)
- Všeobecná úverová banka (SK)

Subsidiaries of non-Euro area EBA Stress tested banks (12)
- RCB Bank (CY)
- SEB (DE)
- AS SEB Pank (EE)
- Swedbank (EE)
- Danske Bank (FI)
- Nordea Bank Finland (FI)
- HSBC France (FR)
- Ulster Bank Ireland(IE)
- AS SEB Banka (LV)
- Swedbank (LV)
- HSBC Bank Malta (MT)
- The Royal Bank of Scotland/RFS Holdings (NL)

Subsidiaries of non-EEA banking groups (4)
- The Bank of New York Mellon (BE)
- UBS (LU)
- RBC Investor Services Bank (LU)
- State Street Bank Luxembourg (LU)

Source: Authors.