AmCham EU
SPEAKING FOR AMERICAN BUSINESS IN EUROPE

Our position

EU-wide stress test

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Executive summary

Post-Brexit the EU banking sector has changed significantly, and it will continue to change as EU subsidiaries of non-EU banks continue to grow their footprint in the Union. It is important the EU supervisory toolkit also evolves, in line with the changed landscape. This requires the willingness to take a fresh look at the existing framework and make the appropriate changes to continue to ensure that tools available to competent authorities are fit-for-purpose. While we understand the potential benefits of having top-down constraints which make stress test results easier to compare, it's important that the results of the test generate a true picture of the resilience of the individual banks.

Ahead of the 2025 stress test, the EBA should examine the existing framework and make the appropriate changes to continue to ensure that the tools available to competent authorities continue to meet their intended objective.

Introduction

Stress testing has become an integral part of day-to-day banking supervision and plays a critical role in assessing industry-wide resilience and determining individual banks' capital requirements. The European Banking Authority (EBA), in cooperation with the European Central Bank (ECB) and the European Systemic Risk Board (ESRB), run the EU-wide stress test across a broad sample of banks which covers roughly 75% of the banking sector in the European Economic Area (EEA).

In 2023, seventy banks participated in the EU-wide stress test. For the first time this included all EU material subsidiaries of US-headquartered banks, because of their increasingly growing importance in the EU banking and capital markets landscape. Despite the severity of the adverse scenario, the results showed that the EU banking sector is on a good footing and would be able to withstand a severe shock. However, the results showed that on average, banks with predominantly 'investment banking' business models showed much higher capital depletions. This could suggest there is a 'business model bias' embedded in some of constraints, which makes the methodology unduly conservative for 'non-Net Interest Income (NII)-intensive' banks.

2023 EU-wide stress test results

On 28 July 2023, the EBA published the results of the EU-wide stress test results which showed that European banks would remain resilient under an adverse scenario entailing a severe EU and global recession, increasing interest rates and higher credit spreads.

As highlighted by the EBA, 'this resilience of EU banks partly reflects a solid capital position at the start of the exercise, with an average fully-loaded CET1 ratio of 15% which allows banks to withstand the capital depletion under the adverse scenario'.

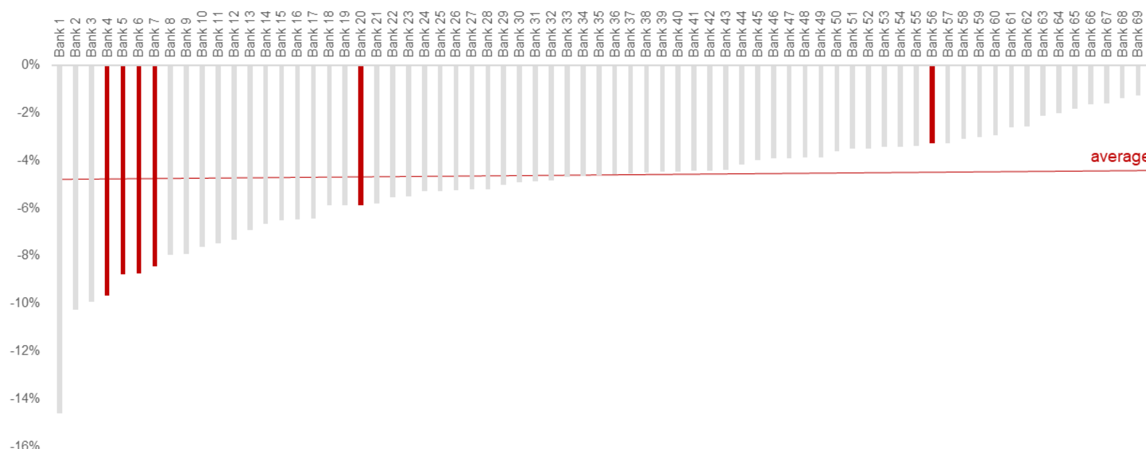
A more granular look at the maximum capital depletions shows that all EU-subsidiaries of US banking groups, except one, showed a significantly above average Common Equity Tier 1 (CET1) capital depletion (red bars). In fact, banks whose business model can be classified as 'investment banking'[1], have shown a 2022-2025 CET1 capital depletion which was 50% higher than that of EBA Tier 1 banks[2], mainly driven by higher market risk losses and lower reliance on the net interest income (NII).

[1] Based on the classification used by the ECB Banking Supervision.

[2] 7.2 percentage points (p.p.), vs 4.2 p.p.

Exhibit 1

CET1 maximum capital depletion – 2023 EU-wide stress test (Subsidiaries of US banks in red)



Source: EBA, 2023 EU-wide stress test results

The interplay between business model/profit and loss (P&L) composition and the methodological constraints foreseen by the EBA Stress Test Methodology explains the much higher capital depletions which EU subsidiaries of non-EU global systemically important banks (G-SIBs) have reported, and the following four sections provide more colour on some of the key elements which weighed on the results.

Business model/P&L composition and EBA constraints

Unlike the average EU bank which is predominately active in 'traditional banking' with sizeable lending books and a huge deposits base, EU subsidiaries of US banking groups are almost exclusively focused on traditional investment banking and capital-market oriented activities. As a result, the 'revenue' profile of these two groups varies widely; more 'traditional' banks tend to show a more prominent reliance on NII, whereas 'capital-market oriented' banks generate revenues from fees & commissions and trading activity (largely driven by client activity with a small share of positional P&L).

At year-end 2022, NII accounted for 56% of the revenues of Single Supervisory Mechanism (SSM) banks, vs only 11% of EU subsidiaries of US banks. However, the sum of Net Fees and Commissions Income and Trading accounted from 39% of the total for SSM banks vs 89% of the EU subs of US banks. Based on the 2022 'revenues mix', the average 'revenues haircut' for a capital market-oriented bank is 2.4 times higher than that of an average SSM bank heavily reliant on NII[3].

The current methodology is not balanced across the main sources of revenues and would benefit from recalibration to ensure the results of the stress test are more aligned to the risk profile of the individual banks. For example, the net trading income (NTI) and the net fees and commission income (NFCI) for certain Fixed Income trading businesses have historically performed better in stressed environments as higher volatility leads to higher trading volumes and therefore increased client revenues, but this is not reflected in (or allowed by) the current stress testing methodology.

[3] SSM banks: (NII 56% * 0% haircut) + (NFCI 31% * 20% haircut) + (NTI 8% * 25% haircut) = 8.1% / EU subs of US banks: (NII 11% * 0%) + (NFCI 54% * 20%) + (NTI 35% * 25%) = 19.7%

Counterparty Credit Risk (CCR)

The current methodology is not risk-sensitive enough as it does not differentiate between cleared and listed derivatives portfolios and 'over-the-counter' (OTC) positions. The EBA should calibrate CCR losses in a way such that centrally cleared and listed transactions are treated differently from OTC positions.

Market risk losses / full revaluation

The current 'floor' foreseen by the methodology is not risk sensitive and does not reflect banks' actual portfolio positioning and prudent risk management, especially for banks with a low market risk profile.

In addition, the one-size-fits-all calibration[4] proves extremely punitive to banks whose balance sheets are mainly composed of trading assets/liabilities. Unlike 'traditional banks' whose trading assets rarely exceed 10% of total assets, capital market-oriented banks have 60-70% of their asset-side at fair value. Hence, in relative terms the impact of the floor is much more severe for capital market-oriented banks than it is for other types of banks, and it can lead disproportionate market risk losses.

Treatment of trading book interest rate derivatives in NII

The current methodology limitation results in outsized net revenue projections for trading book interest rate derivatives. This is because banks are required to calculate theoretical NII on derivatives with interest rate underliers and to project this through the baseline and adverse scenarios.

However, banks do not risk manage positions in this way; trading book interest rate derivatives risk is already appropriately captured in the EBA market risk template and is more reflective of how the book is managed. Banks hold and manage their trading book interest rate derivatives at fair value. The EBA should exclude trading book interest rate derivatives from the NII template.

Discretionary distributions

Wholly owned subsidiaries of third-country banking groups are not listed in the EU and are therefore not required to publicly disclose their dividend policies, as distribution policies are covered by internal policies. Because of this, more flexibility should be introduced which would allow subsidiaries of third-country groups to rely on internal capital management policies instead of applying the prescriptive rule foreseen by the current methodology.

Likewise, regarding variable remuneration and administrative expenses, a bank with a proven track-record (ie can demonstrate that in previous economic downturns variable compensation and administrative expenses declined) should be allowed to reduce these expenses, especially variable remuneration for the most senior members of staff.

Conclusion

Stress tests have become an important tool for supervisors in the wake of the financial crisis, and all major jurisdictions, including Europe, have benefited greatly from their use. Nonetheless, it is important that stress testing methodologies keep up with the changes in the banking ecosystem to continue to remain realistic and relevant. The current review provides a good opportunity to achieve this.

[4] For held for trading instruments, the full revaluation loss under the adverse scenario is capped at a haircut of 0.20% of the sum of fair value asset and liabilities. A VaR scaling factor is then applied to the final loss.