

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

Willem Pieter de Groen and Karel Lannoo

23 October 2014

With the results of its asset quality review (AQR), to be published on Sunday, October 26th, the European Central Bank intends to provide clarity on the soundness of the 120 banks it will supervise in the eurozone. In addition, 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 establishing its ability to perform future tasks, whereas EBA seeks to restore the confidence it lost in the 2011 stress test. 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.

Over the past 12 months, 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 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 minimum of 8% Common Equity Tier 1, following the CRDIV, but it assesses the resilience of

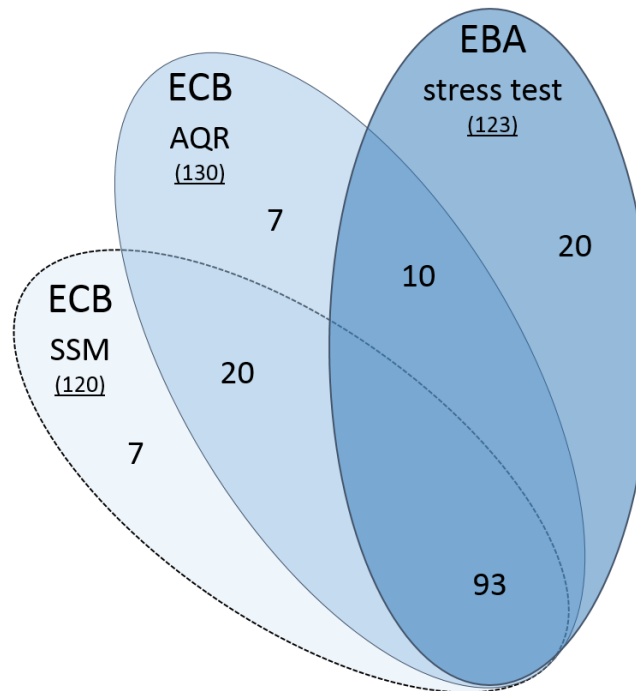
Willem Pieter de Groen is Researcher and Karel Lannoo is the Chief Executive Officer and Senior Research Fellow at CEPS.

CEPS Commentaries offer concise, policy-oriented insights into topical issues in European affairs. The views expressed are attributable only to the authors in a personal capacity and not to any institution with which he is associated.

Available for free downloading from the CEPS website (www.ceps.eu) • © CEPS 2014

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 banks directly supervised under the SSM, banks subject to the ECB AQR and/or the 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 EU banks in our sample increased their Tier 1 ratio substantially over the last years, from 8% in 2006 to 13% in 2013, whereas the common equity level improved only moderately, from 4.0% to 4.7% over the same period (see Figures 2 and 3), which is a reflection of the decline of risk-weighted assets as a share of total assets.

Figure 2. Tier 1 capital ratio (% of RWAs)

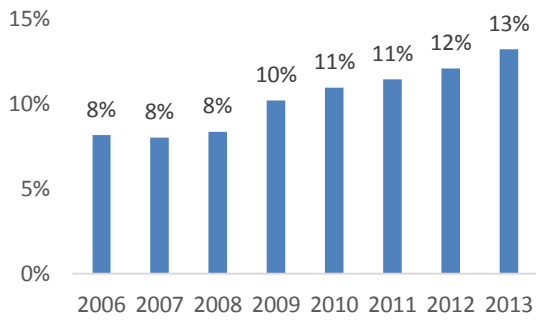
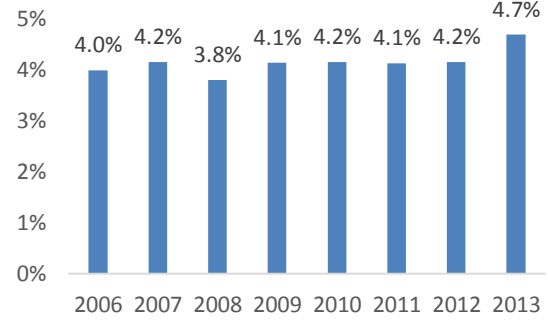


Figure 3. Tangible common equity (% of assets)

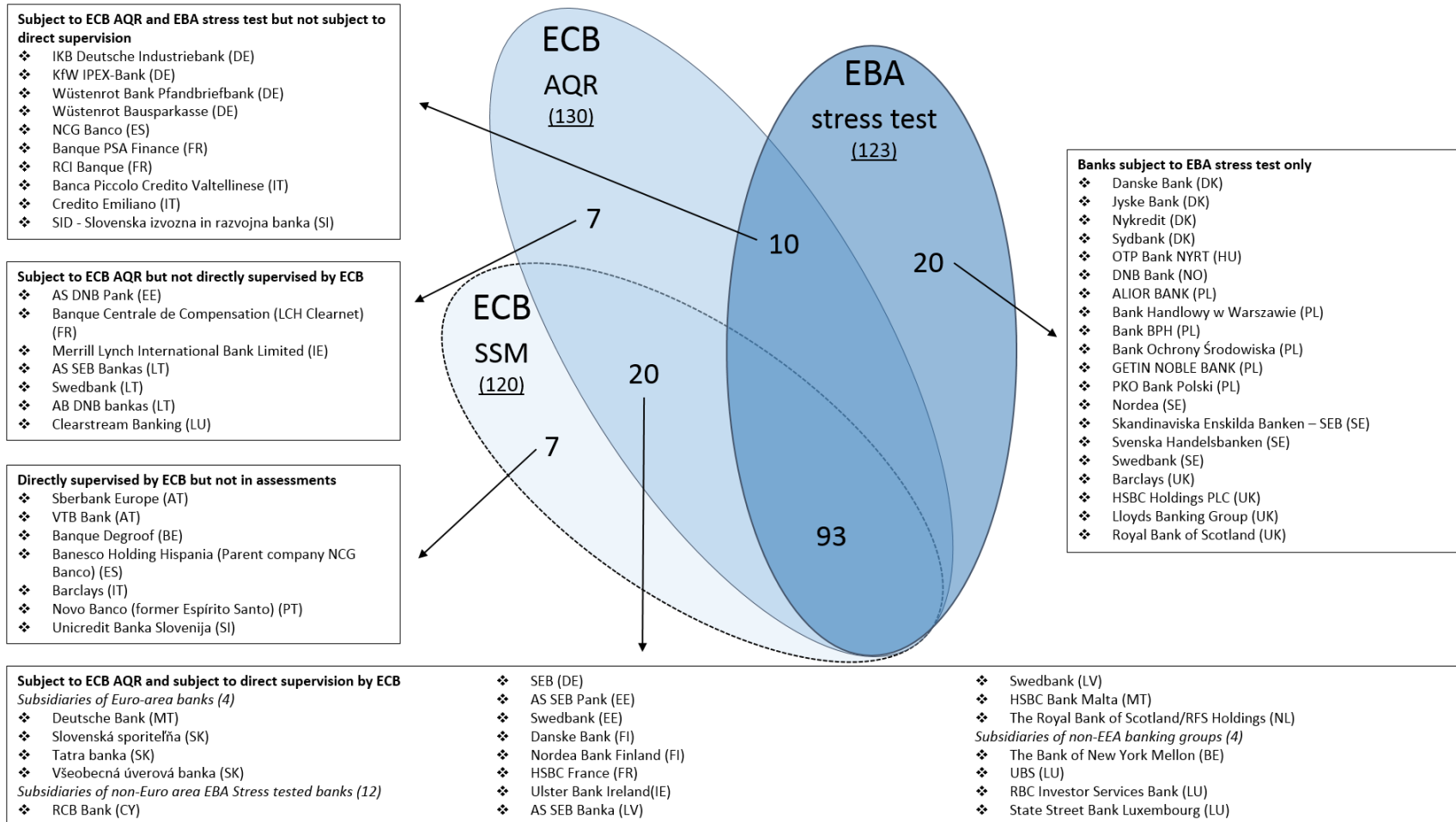


Note: The amounts expressed in the figures are median values for 147 European banking groups.

Source: R. Ayadi 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 banks directly supervised under the SSM, banks subject to the ECB AQR and/or the EBA stress test



Source: Authors.