BRIEFING

European Parliament

Regular Public hearing with Danièle Nouy, Chair of the ECB Supervisory Board

ECON on 19 June 2018

This note is prepared in view of a regular public hearing with the Chair of the Supervisory Board of the European Central Bank (ECB) in ECON, scheduled for 19 June 2018.

The following issues are addressed in this briefing: (i) Brexit; (ii) the policy debate as to whether and how the EU supervisory approach to Anti-Money Laundering (AML) could be further strenghened; (iii) the latest release of the ECB's Supervisory Banking Statistics; (iv) summaries of recent ECB/SSM publications (v) as well as summaries of external briefing papers provided for the ECON Committee which analyse the settings of the ongoing EBA/ECB stress test.

I. Brexit

The ECB and the Bank of England jointly announced in April 2018 that they will be convening a "**joint technical working group on Brexit-related risks"**. That technical working group - co-chaired by the President of the ECB and the governor of the Bank of England - is separate from the on-going negotiations on the Withdrawal Agreement. It involves the European Commission and the UK Treasury as observers. The focus of the work is on "risk management in the period around 30 March 2019 in the area of financial services", where cliff-edge risks are likely to arise in the absence of a Withdrawal Agreement ('hard Brexit'), should the Withdrawal Agreement that includes the transition period be voted down. This joint technical working group has not made public any conclusions or specific warning so far.

In its November 2017 financial stability report, the Bank of England already emphasised that "*it will be difficult, ahead of March 2019, for financial companies on their own to mitigate fully the risks of disruption to financial services*". Bank of England's stability report particularly insists on the risks that the **continuity of existing derivatives contracts** may pose to financial stability. Ahead of Brexit, financial firms would need to move uncleared OTC derivative contracts to legal entities ('novation') that do have the appropriate permissions (e.g. legal entity based in the EEA) as financial firms, by losing passporting rights, might no longer have permissions to carry out these activities post Brexit. The Bank of England is particularly concerned with the operational challenge that such repapering would entail: "*Each major dealer will have several thousand counterparties, with whom contracts will require renegotiation, potentially impacting tens of thousands of underlying clients. There are no*

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precedents for these types of multiple large-scale novations within an 18-month period. Given the scale and the complexity involved, firms may not be able to mitigate the risks fully by exit". According to the Bank of England's data, the gross notional amount outstanding of these affected contracts is around £26 trillion, of which £12 trillion matures after 2019 Q1. Against this background, the Bank of England recommends UK and EU legislation to ensure continuity of outstanding uncleared derivatives contracts.

In contrast, in its April 2018 report on risks and vulnerabilities in the EU financial system, **the European Supervisory Authorities' Joint Committee** emphasised that *"Market participants need to prepare for the risk of reduced access to market infrastructure and contract continuity upon the UK's withdrawal from the EU. Financial institutions are responsible for ensuring that they are able to fulfil their contractual obligations under all circumstances, not least with respect to derivatives, liquidity provision, and swap contracts EU 27 parties have entered into".*

Preparadeness of firms is at the very heart of SSM's approach to Brexit. At its first ordinary ECON hearing in June 2017, the Chair of the SSM explained that the ECB has asked banks to plan for a worst case scenario (i.e. no withdrawal agreement, no transition and no equivalence). The focus of the SSM work is on operational aspects related to a possible relocation of UK-based banks to the euro area. In that respect, the ECB has laid down procedures for the relocation of banks to the euro area in the context of Brexit that are kept updated on its web site. The ECB has particularly insisted on the importance it attaches to adequate local risk management and governance structures in the eurozone so as to **avoid the creation of 'empty shells'** in the eurozone. This led the SSM to specifically address booking models and 'back branching'. Back-branching refers to a situation where a legal entity established in the EU would serve its EU clients via its branch located in a third country (the UK). The ECB put clear limits to back-branching by clarifying in its Frequently Asked Questions on relocation that the "*ECB and the national supervisors believe that the purpose of branches in third countries is to meet local needs. The ECB and national supervisors do not expect that branches in third countries perform critical functions for the credit institution itself or provide services back to customers based in the EU*".

The deadline for firms to submit authorisation applications has been set by the ECB "at the very latest by the end Q2 2018", with a view to obtaining the required authorisations before 29 March 2019. This means that all banks that wish to relocate in the eurozone should have already started their application process.

The ECB has clarified that an agreement on a transition agreement does mean that firms should stop their preparadeness: "*there is still political uncertainty as to whether there will be a transition period. Legal certainty will only come with the ratification of the Withdrawal Agreement by all sides involved in the negotiations. The ECB is therefore not in a position to assume that such a transition period will be agreed upon. The ECB and national supervisors, therefore, expect banks to continue to prepare for all possible contingencies, including a no-deal scenario leading to a hard Brexit with no transition. Banks are responsible for ensuring that all authorisations required for them to carry out their activities as envisaged are in place in a timely manner*".

II. Anti-Money Laundering ('AML') framework

At the March 2018 ECON hearing with the Chair of the SSM and the subsequent April 2018 TAX3 hearing[1], the European Parliament has launched a debate as to whether and how the supervisory architecture should be better designed to ensure an effective application of the AML framework. For further details on the recent AML cases and the policy debate, please see a separate EGOV briefing.

The Commission[2] set up a working group in May 2018 involving the Commission services, the SSM and the three European Supervisory Authorities (EBA, ESMA and EIOPA) to "identify specific actions to be taken by the respective authorities, in order to improve the practical coordination of AML supervision of financial institutions, in the short term and beyond". To that end, the Commission has identified six possible actions that the working group would further work out (see box 1). That working group is expected to come up with a list of deliverables and actions by the end of July 2018.

The European Supervisory Authorities and the SSM have already positioned themselves on some issues identified by Commission's action plan:

Box 1: Possible actions identified by Commission for consideration by the AML working group

- **Action 1**: Better use of the **European Supervisory Authorities** powers to ensure the correct application of EU law and supervisory convergence by national AML authorities;
- **Action 2**: Better integration of **AML considerations into prudential supervision**;
- **Action 3**: Greater use of **supervisory colleges** to consider AML issues;
- **Action 4**: More clarity on when and how the power to **revoke a banking licence** (or other financial institution's license) can be used in the case of money laundering concerns;
- **Action 5**: Improving **coordination and exchange of information**;
- **Action 6:** Consideration of any further steps necessary for a stronger common Union approach to AML supervision and compliance.

Source: Commission's letter to SSM and ESA

Action 1: As to a **better use of the ESAs**, EBA pointed out at the EP TAX3 hearing that its powers to enforce standards and guidelines are limited: "*we do not supervise individual financial institutions and we do not currently have the legal tools to enforce compliance in a way that would compel a competent authority to change its approach*". EBA may investigate a breach of Union law, and issue recommendations, but "they cannot make up [...] for weak or ineffective supervisory practices".

As explained at the EP TAX3 hearing, EBA would in any case lack resources to perform all the tasks referred to in the EBA Founding Regulation (See Part 3 above). EBA staff involved in AML has been recently reinforced from 1 to 2 persons. The EBA asked for "sufficient powers and resources to enable the EBA to take action where necessary to support the correct and consistent application of EU AML standards and guidelines".

1 Public hearing 'Combat of Money Laundering in the EU Banking Sector' organised by the European Parliament's Special Committee on Financial Crimes, Tax Evasion and Tax Avoidance (TAX3) on 26 April 2018.

2 Letter from F. Timmermans, First Vice-President of the European Commission, V.Dombrovskis, Vice-President of the European Commission and V.Jourova, Commissioner, to Danièle Nouy, chair of the SSM, A. Enria, chair of EBA, G. Bernardino, chair of EIOPA and S. Maijoor, chair of ESMA.

Action 2: When it comes to the **integration of AML consideration into prudential supervision**, the Chair of the SSM in a letter dated 3 May 2018 confirmed that "*the SSM Supervisory Review and Evaluation Process (SREP) includes the components necessary for a comprehensive prudential treatment of AML risk, within the limits of its competence and in the light of information available*" [our emphasis], as part of the assessment of banks' internal governance, operational risk and business models. Put it another way, AML consideration are already integrated into prudential supervision, provided that information is made available to the SSM by national authorities responsible for AML supervision. In that respect, the Chair of the SSM has repeatedly explained that the supervisory framework does not guarantee that the SSM would receive information in a timely manner.

Action 3: Regarding the **greater use of supervisory colleges**, the EBA already stressed at the EP TAX3 hearing that "it will expect that competent authorities that are responsible for the AML/CFT supervision of financial institutions that operate on a cross-border basis liaise regularly with their counterparts in other Member States".

Possible involvement of ESAs in colleges has not been specifically and publicallry discussed yet. Article 21 of the ESAs Founding Regulation on supervisory colleges entrusts ESAs with the power of "*collect[ing] and shar[ing] all relevant information in cooperation with the competent authorities and [...] promot[ing] effective and efficient supervisory activities, including evaluating the risks to which financial institutions are or might be exposed as determined under the supervisory review process*". Those provisions are not prudential specific and may extend, where appropriate, to AML considerations which are scoped in in the ESA Founding Regulation (See Part 3 above). Colleges might involve both AML and prudential authorities although colleges are currently used mainly for prudential purposes.

Action 4: As to further clarity on **when and how the power to revoke a banking license** can be used where "serious breaches" of AML requirements have been picked up, the SSM emphasised in a letter dated 3 May 2018 that there is "*always a need for supervisory discretion on a case-by-case basis*". The ECB also stressed that "*the fact that AML powers lie at national level means that one of the reasons for licence withdrawal remains under national authorities' control*".

Action 5: In terms of an **enhanced coordination and exchange of information** framework, the 5th AML Directive adopted by the EP on 19 April has lifted legal restrictions in terms of confidentiality that prevented the exchange of information between AML authorities and prudential competent authorities. In addition, National prudential competent authorities and the European Central Bank (as banking supervisor in the Banking Union) shall conclude, with the support of the European Supervisory Authorities, an agreement on the practical modalities for exchange of information.

The Chair of the SSM identified in a letter dated 3 May 2018 the following limits to the exchange of information: i) allowing the exchange of confidential information as provided for in the 5th AML Directive does not mean that AML authorities will share all relevant information with bank supervisor in a timely manner; ii) the cooperation framework foreseen in the 5th AML Directive would not be swiftly set up. In that respect, the chair of SSM called for the establishment of a new Authority as a way to improve and strenghten the cooperation framework (see below).

Action 6: Further steps necessary for a **stronger common Union approach to AML supervision** and compliance.

The SSM has called for the **establishment of a European Authority** that will be distinct from the ECB/SSM (see box 2 below). The Chair of the SSM further explained in a letter dated 3 May 2018 the limits of what the existing supervisory and coordination framework may achieve: "*as anti-money laundering concerns both the supervisory and criminal/judicial spheres, reviewing the [AML] Directive may not suffice to ensure cooperation is smooth and all-encompassing. Establishing a European AML authority could bring about such a degree of improved cooperation*".

National authorities involved in recent alleged breaches of AML requirements that attended the April 2018 TAX3 hearing - the Financial and Capital Market Commission in Latvia and the Malta Financial Services Authority (MFSA) also positioned themselves in favour of an EU Authority. In particular, the MFSA explained that networks to exchange information would be greatly beneficial, but would be difficult to implement in practice. As an alternative to cooperation arrangements, the MFSA suggested the "*establishment of a centralised EU-wide due diligence/intelligence team which could be a point of liaison with the US and other key authorities around the world and with which national competent authorities could liaise with as part of their due diligence checks at authorisation as well as on an on-going basis*".

Box 2: ECB's public statements in relation to a possible new EU supervisory architecture

In an interview in March 2017, Danièle Nouy emphasised that whether money laundering and financing of terrorism should be supervised centrally, is a "decision for politicians and legislators to make", but the Single Supervisory Mechanism cannot take on such responsibility for the following reason: "we already have many tasks which require our full attention. Moreover, we already work closely with the 19 national competent authorities that undertake banking supervision for the countries of the euro area. [...] As anti-money laundering is not necessarily located in the NCAs or NCBs, it would mean having additional "partners" within the SSM, which would add complexity".

In addition, at the April 2018 TAX3 hearing on AML, the ECB explained that there may be legal impediments to entrusting ECB with further responsibilities in the field of AML given the legal basis (Article 127(6)) on which the SSM has been established. AML regulation applies to all financial sector while Article 127(6) explicitly rules out ECB supervisory tasks for insurance.

At the 26 March ECON Committee hearing, reacting at the ABLV case, Danièle Nouy called for an EU agency to be set up to police anti-money laundering rules: "we need an European institution that is implementing in a thorough, deep, consistent fashion this legislation in the Euro area [...] We need to change the situation. It's not sustainable to stay in that situation". Of particular concern were "countries that are not equipped with enough staff and enough expertise".

III. Supervisory Banking Statistics

Since the second quarter 2016, the ECB publishes aggregate Supervisory Banking Statistics on directly supervised significant banks; the dataset regularly reports on general statistics, balance sheet composition and profitability, capital adequacy, leverage and asset quality, funding, liquidity, and data quality.

The data published on 30 April 2018 for the fourth quarter 2017 show that there is, compared to the situation one year ago, again an improvement across most key indicators (see Annex 1). The most important developments can be summarised as follows:

As regards asset quality, the **average NPL ratio** of the most significant banks has again improved and fallen below 5% at the end of 2017 (Q4 2017: 4.92%, as compared to 6.15% in Q4 2017).

The focus of the ECB Supervisory Banking Statisticsis on the average NPL ratio. From a risk-monitoring perspective information on how outliers have developed could be more relevant, given the wide differences between banks' individual NPL ratios across and within Member States. That information, however, is not part of the Supervisory Banking Statistics.

The **average capitalisation level** saw an improvement as well: CET 1 ratios stood on average at 14.58% in Q4 2017 as compared to 13.78% in Q4 2016, hence 0.8 percentage points (pp) higher.

Looking at the factors that have driven the improvement of the CET1 ratio, one can observe that the increase in capital (plus 1.8%) itself has contributed less to that development than the reduction of the balance sheet size, which has come down by some 4.5% over the one-year period under consideration. The deleveraging hence drives up the capitalisation levels.

The **banks' profitability** (measured in terms of "Return on Equity") has seen a considerable improvement on a year-to-year basis, though fourth quarter results were not as good as those in the previous three quarters of 2017.

Analysing the sources of the banks' improved aggregate[3] profitability (see table 1), which in a year-to-year comparison are on average nearly 90% higher, the trend already described in the previous EGOV briefing still holds true: The main source of banks' income – **net interest income – has in fact slightly declined** (minus 1.5%), but that development was overcompensated by two factors that are relevant both in relative and absolute terms: **Net trading income increased** by some 56%, while **impairments and provisions came down** by 31%. Income from trading activities is notably a source of income that is mainly available to large and very large banks: the 7 largest banks in the sample (the "G-SIBs") booked 75% of the aggregated net trading income in Q4 2017 (see table T02.01.3 in the ECB's supervisory statistics).

[3] One caveat to be kept in mind when analysing the aggregate data is that the composition of the sample changes over the one-year period under consideration, banks are added to or taken off from the list of directly supervised institutions, or they are sold or merged. Specifically, there were 121 banks in the fourth quarter of 2016, 118 in the first quarter of 2017, 114 in the second and third quarter of 2017 and 111 in the fourth quarter of 2017.

Table 1: Aggregated profit and loss figures of directly supervised banks by reference period

Profit and loss	Q4 2016	Q4 2017	Change y-t-y
Net interest income	262.731,83	258.892,76	-1,5%
Net fee and commission income	130.505,45	136.266,43	4,4%
Net trading income	23.139,00	36.068,66	55,9%
Exchange differences, net	2.981,15	1.340,79	-55,0%
Net other operating income	42.889,07	22.367,39	-47,8%
Operating income	462.246,50	454.936,04	-1,6%
Administrative expenses and depreciation	-304.270,86	-292.915,05	-3,7%
Net income before impairment, provisions and taxes	157.975,64	162.020,99	2,6%
Impairment and provisions	-101.887,38	-70.267,36	-31,0%
Other	11.471,59	19.229,05	67,6%
Profit and loss before tax from continued operation	67.559,85	110.982,67	64,3%
Profit and loss before tax from discontinued operation [5)]	-13,21	3.706,81	
Tax expenses or income	-22.594,58	-29.445,24	30,3%
Net profit/loss	**44.952,05**	**85.244,25**	**89,6%**

Source: ECB Supervisory Banking Statistics for Q4 2017, extract from table T02.01.1

The **Liquidity Coverage Ratio** (LCR) is in a year-to year comparison quite significantly higher, showing an improvement by 7.5 pp (Q4 2017: 143.6%, as compared to 136.1 % in Q4 2016).

As regards the LCR, the most recent Supervisory Banking Statistics also point to an issue that apparently needs to be addressed**:** According to Regulation (EU) 2015/61, Article 38, banks have to maintain an LCR of at least 100 % as from 1 January 2018. At the end of 2017 – so technically the day before the 100% LCR level became binding – the four significant Greek banks **still had an average LCR ratio below 100% (see table 2).**

Table 2: Liquidity coverage ratio band by country (number of significant institutions)

Country (Q4 2017)	LCR ≤ 100%	100% < LCR ≤ 150%	LCR > 150%
Belgium	-	3	4
Germany	-	4	16
Estonia	-	-	-
Ireland	-	3	2
Greece	4	-	-
Spain	-	3	9
France	-	5	5
Italy	-	4	7
Cyprus	-	-	4
Latvia	-	-	1
Lithuania	-	-	1
Luxembourg	-	3	1
Malta	-	-	2
Netherlands	-	3	3
Austria	-	5	2
Portugal	-	1	2
Slovenia	-	-	3
Slovakia	-	-	-
Finland	-	1	1
Total	4	35	63

Source: ECB Supervisory Banking Statistics Fourth quarter 2017, table T05.02.2, p. 117

IV. Recent SSM publications

Thematic Review on effective risk data aggregation and risk reporting

On 8 May 2018, the ECB published the Report on the Thematic Review on effective risk data aggregation and risk reporting. That report finds that a bank's ability to manage risk-related data has a significant impact on its overall risk profile and the sustainability of its business model, especially when a bank faces a difficult economic situation. The ECB therefore pays close attention to data quality, risk data aggregation and risk reporting capacities.

In 2016, the ECB started an in-depth assessment of the banks related capabilities on a sample of 25 significant institutions, using the Basel Committee's principles for effective risk data aggregation and risk reporting (the so-called "BCBS 239 principles") as guidance.

The report points out that the implementation of the principles of the Basel committee is unsatisfactory, which is a source of concern: None of the significant institutions assessed have fully implemented the BCBS 239 principles. Weaknesses are said to stem in particular from a lack of clarity regarding responsibility and accountability for data quality. The report describes the key areas of concern and observed good practices in more detail.

2018 stress test of Greek banks

On 5 May 2018, the ECB published the stress test results for the four significant Greek banks (Alpha Bank, Eurobank, National Bank of Greece - NBG - and Piraeus Bank). Those banks underwent a stress test following the same methodology and approach as in the ongoing EU-wide EBA exercise, but with an accelerated timetable in order to complete the test before the end of the European Stability Mechanism's Stability Support Programme for Greece in August.

In the adverse stress scenario, the banks' capital was on average depleted by 9 percentage points. Overall, even though the 2018 stress test scenario resulted in a higher capital depletion than in a similar exercise carried out in 2015, the residual levels of CET1 capital were still stronger, benefitting from significantly higher levels of CET1 available at the starting point. The residual levels of CET1 capital in the adverse stress scenario were estimated to be in 2020: 9.69% for Alpha Bank, 6.75% for Eurobank, 6.92% for NBG, and 5.90% for Piraeus Bank.

In the 2018 exercise, there was no predetermined pass-or-fail level specified, and the ECB explained that "*any recapitalisation decision will be taken on a case-by-case basis, after assessing each bank's situation in the light of the results of the stress test and any other relevant supervisory information, following a holistic approach*". For more details, please see a separate EGOV briefing.

ECB opinion on the ESA review

In its opinion on the ESA review adopted in April 2018, the ECB has called for a differentiated approach across sectors, arguing that the Banking Union and the Capital Market Union are at different stages of progress. The ECB considers it "vital" that synergies arising from the ECB's microprudential supervisory tasks and the EBA's competence to set regulatory standards to promote supervisory convergence are maximised. For this purpose, the ECB recommends that any duplication or "*inappropriate allocation of tasks which could blur the responsibilities*" of the SSM and the EBA be avoided.

Against this background, the ECB particularly objects to the following new supervisory convergence tools in the banking sector that may interfere with ECB's supervisory tasks:

- The ECB considers that "*conferring strategic planning powers on the EBA is inappropriate"* on the ground that *"Identifying micro-prudential trends, potential risks and vulnerabilities for financial institutions, and defining respective strategic supervisory priorities, are core supervisory*

tasks that should be carried out by the competent micro-prudential supervisory authority, and not the EBA in its function as a standard-setting regulator";
- With respect to EBA's task to scrutinise delegation and outsourcing of activities, the ECB is of the view that this coordination role would "*overlap with micro-prudential supervisory tasks carried out by the ECB in the context of the SSM, and could add an unwarranted layer of administrative burden in the supervisory process*".

In contrast, on the regulatory front, the ECB recommends further extending EBA's role in developing a transparency framework for financial institutions by integrating supervisory reporting and quantitative Pillar 3 disclosure requirements into a single reporting framework. This might take the form of a central data repository at the EBA that would facilitate market participants' access to information.

V. External briefing papers on the 2018 stress test design

On request of ECON coordinators, the panel experts were asked to assess whether from their point of view the 2018 EU-wide stress test (and in particular the adverse macro-financial scenario) is internally consistent, whether the design and parameters are more demanding than those of previous EU-wide stress test exercises, and whether it would be recommendable to have more demanding scenarios, additional elements, or additional explanations, also in view of practices and developments outside of the Banking Union.

The papers point to some potential weaknesses in the stress test's overall design, and outline some recommendations how to to improve the design.

Brunella Bruno and Elena Carletti

Weaknesses identified by Bruno and Carletti are as follows:

- The **static-balance sheet rule** - which says that management's individual interventions to deal with the stress scenario cannot be taken into account - makes the stress results more comparable , but at the expense of plausibility. Since the basic assumption is irrealistic, the use of the results as a communication tool for investors and for internal purposes is limited.
- Bruno and Carletti also highlight that a rigorous assessment on banks' **liquidity position** is not adressed in the stress test scope. Mentioning that the global financial crisis has clearly shown an interconnection between liquidity and solvency shocks, and the importance of liquidity problems in the recent resolution case of Banco Popular, they recommend that this interconnection should be better taken into account in the overall design of the test.
- As regards the **pass-fail threshold**, they concur with the perception that the lack of a threshold forces investors to make themselves more familiar with the technicalities behind the test. They assume, on the other hand, that in the absence of a fail-pass judgment and in view of the uncertainty as to how the results exactly feed into the supervisory review and evaluation process (SREP), bank creditors will still benchmark the banks' performance in the adverse scenario based on the variation of banks' CET 1 at the end of exercise. Whatever the criterion used to benchmark banks after stress test results disclosure, Bruno and Carletti find it reasonable to expect a differentiation in the risk premium demanded by investors for bank liabilities.

Bruno and Carletti find that those areas should be addressed in a future stress test design in order to enhance the reliability of its results and to empower their role as external and internal communication tools.

Andrea Resti

Weaknesses identified by Resti are as follows:

- In order to ensure that all simulations are carried out in a comparable way by all participating banks, a number of constraints are introduced through a standard methodology defined by the EBA. Some of those **constraints may prove especially binding for commercial banks** transforming deposits into loans with some degree of maturity mismatch.
- The **combined effect** of certain rules (rules on non-performing exposures, the assumed **"asymmetric pass-through"** of higher funding that cannot entirely be translated into higher lending rates, and the "static balance-sheet approach) may pose a **challenging situation for non-investment grade banks** operating in the periphery of the euro area.
- So-called **level 2/3 financial instruments** are assets and liabilities that are hard to price, difficult to trade and therefore might become highly illiquid. According to the design of the 2018 stress test, the effects of the stress parameters are calculated based on the banks' internal pricing models. The results of such models, however, are hard to scrutinize, given that most level 2/3 assets have complex pay-out structures, depending on a large number of unobservable risk factors that must be estimated via sophisticated procedures. There is hence a risk that the 2018 methodology may provide a **"false sense of security"** when it comes to the resilience of institutions holding a considerable portfolio of illiquid, hard-to-price financial instruments.
- An additional layer of constraints may come from the **"benchmark models"** used by competent authorities to scrutinize the banks' bottom-up results. While such models may play a beneficial role in making supervisory expectations more uniform and transparent, they are **not subject to the public consultation process** that leads to the EBA methodology, hence their possible weaknesses and inability to capture bank specificities may prove harder to challenge.
- The EBA methodology aims to align the stress test exercise with **IFRS 9**. However, the rules show several simplifications and constraints that are not entirely consistent with the actual requirements of the new accounting standard, therefore create an additional layer of complexity, and may in particular result in overstating the funding costs.

To improve the stress test design, Resti suggests the following:

- The key to making future stress tests more consistent and equally demanding for all types of institutions does not (only) lie in further methodological refinements. It calls for the **whole management of the stress test exercise** to be revisited, addressing weaknesses in terms of budgetary resources, technical skills and governance. In this context, Resti points in particular to the merits of a stronger operational role of the EBA, which would also benefit from more staff with stress test expertise.
- Transparency requires that the content of **benchmark models is disclosed** in advance. Some progress has been made in this respect, however, details (e.g. country-specific calibrations of the models) are still kept confidential, making it hard for outsiders to challenge the soundness and plausibility of the models.The EU legislator may require EBA to provide the public with a clear report of all significant exceptions or even entrusts EBA with the power to veto proposals by competent authorities that override the agreed methodology.
- A **dialogue between supervisors and banks** can benefit from increased transparency on benchmark models, in order to enable banks to perform a comparison between the latter and their own algorithms, identifying and addressing weaknesses.

Rainer Haselmann and Mark Wahrenburg

Key weaknesses identified by Haselmann and Wahrenburg are as follows:

- In terms of **country specific calibrations**, Haselmann and Wahrenburg acknowledge that the adverse scenario constitutes the most severe scenario compared to previous EU stress tests, but they highlight that the country-specific calibration implies a highly asymmetric impact of the scenario: countries with a high degree of trade openness seem to be more affected compared to countries with lower openness.
- While the question of **internal consistency in the market risk scenario** cannot be answered with a simple "true" or "false", the expert judgement reveals some particular areas where consistency seems to be weak and questionable: The authors mention, for example, that the stress test scenario postulates both a severe global recession and a rather strong increase of long term government bond yields in Europe, which they deem highly unlikely to happen at the same time. They point out that the US stress test by the Federal Reserve assumes a decline rather than an increase of interest rates: Empirical experience suggests that an increase of risk aversion drives investors to "safe havens", the interest rates of countries perceived as safe haven therefore decreases. Inconsistent with that experience, the EBA stress test foresees government bond yield increases for all countries.
- As regards the **impact of IFRS 9,** Haselmann and Wahrenburg take a different view than Resti. They believe that IFRS 9 will have an important impact on the EBA stress test results in the long run and make the test more severe, however, they expect that the European transitional arrangements will allow banks to completely neutralize these effects in the derivation of the 2018 stress test results and even improve their capital ratios instead.

In terms of recommendations, Haselmann and Wahrenburg suggest the following:

- Haselmann and Wahrenburg critise the **lack of transparency** regarding certain stress test details. In particular the translation of the ESRB macro-financial adverse scenario into risk parameters affecting bank balance sheets has to become more transparent and standardized in order to improve market discipline. While some risk parameters are made public (those used to calculate the stress scenario impact on the bank's trading books), those benchmark parameters that are economically much more important and impact the banking book, loan losses, and changes in risk weighted assets, are communicated by EBA only to banks which may not share the information with other parties. Without this information, however, market participants cannot evaluate whether an adverse scenario has been consistently applied to all banks.
- The "bottom-up approach" to forecast scenario-implied losses, which relies on banks' internal calculations of stress test results, provides banks with too much flexibility, which adversely impacts the credibility of the stress test results. They argue that **the "top-down" approach used for stress tests in the US is presumably preferred** by capital market investors, as it takes away the discretion inherent in the EU approach.

Finally, Haselmann and Wahrenburg made a **forecast of credit losses from the 2018 ESRB adverse scenario**, based upon a methodology developped by Camara et al., though the actual stress test results will only be published in November 2018. Based on that methodology, they estimate that the 2018 stress test scenario will probably result in smaller credit losses compared to the previous exercise in 2016, even though the most severe scenario in terms of GDP decline is applied, considering that actual macroeconomic situation in the EU has improved between 2016 and 2018.

Annex 1: Overview of key indicators from the ECB's Supervisory Banking Statistics

	Q4 2016	Q1 2017	Q2 2017	Q3 2017	Q4 2017
Balance sheet composition (EUR billions; percentages)					
Total assets	21,737.69	21,928.62	21,376.42	21,298.37	20,752.63
Total liabilities	20,337.29	20,498.73	19,969.69	19,877.56	19,327.26
Equity	1,400.40	1,429.89	1,406.73	1,420.81	1,425.37
Non-performing loans ratio	6.15%	5.90%	5.49%	5.15%	4.92%
Key performance indicators					
Return on equity	3.21%	7.06%	7.08%	7.03%	5.98%
Return on assets	0.21%	0.46%	0.47%	0.47%	0.41%
Capital and leverage ratios					
CET 1 ratio	13.78%	13.74%	13.88%	14.32%	14.58%
Tier 1 ratio	14.72%	14.75%	14.88%	15.32%	15.57%
Total capital ratio	17.30%	17.44%	17.56%	17.97%	18.08%
Leverage ratio (transitional definition)	5.39%	5.29%	5.33%	5.39%	5.57%
Leverage ratio (fully phased-in definition)	5.04%	5.04%	5.08%	5.17%	5.38%
Funding					
Loan-to-deposit ratio	120.02%	119.39%	118.16%	117.54%	116.91%
Liquidity					
Liquidity coverage ratio	136.09%	141.72%	142.79%	140.39%	143.63%
Only banks that are required to report liquidity information at the highest level of consolidation in the SSM are aggregated in the liquidity coverage ratio shown above.					

Source: ECB Supervisory Banking Statistics

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