AT A GLANCE

Research papers on the 2014 ECB Stress Test

The European Central Bank (ECB) is about to take on its new banking supervision tasks. In preparation for that the ECB carries out a financial health check of all banks to be supervised, consisting of an asset quality review and a stress test. Given the importance of those preparations, the Committee on Economic and Monetary Affairs has commissioned two experts to assess the "**Robustness, Validity and Significance of the ECB's Asset Quality Review and Stress Test Exercise**".

One of the two studies was carried out by **Thomas Breuer**, University of Applied Sciences Vorarlberg. Some of his **key findings** are outlined below (see flip page for the results of the second study):

*The ECB stress test works with **two macroeconomic scenarios**, a normal (baseline) scenario and an adverse scenario if things turn bad. Breuer finds that the ECB stress test for 2014 has indeed some **plausibility**, since the adverse scenario is as extreme as the extreme moves in the period 2002-2013.*

*However, Breuer highlights that no macroeconomic scenario determines balance sheets unambiguously since scenario values of the macroeconomic **indicators have to be translated** into risk parameter values. For that translation banks will use their internal models which are not known to the outside world; it is thus difficult to judge the severity of the resulting scenario in terms of risk parameters.*

Breuer considers that the ECB's assessment in 2014 has a number of strengths, namely

- *that the 2014 EU stress tests make **definite progress** on the 2011 stress tests in that the adverse scenario considered in 2014 is more severe than the one in 2011. The scenario strikes a **good balance** between severity and plausibility, and*
- *that the more active involvement of the ECB side by side with the national competent authorities fosters **equal treatment** of major banks across the EU. The asset quality review has the potential to provide undisputed and reliable initial balance sheets serving as starting points for the stress tests.*

Yet, Breuer also notices some weaknesses:

- *The restriction of attention to one adverse scenario might foster an **illusion of safety**. Banks faring well in this one scenario are not necessarily safe in other scenarios.*
- *The static balance sheet assumption together with the specification of a fixed scenario independent of the reaction of banks amounts to **neglecting second round effects**.*
- *Banks are allowed and encouraged to make **heavy use of their internal models** in working out the balance sheet implications of the macroeconomic scenarios. Although the internal models are to be checked by the supervisors, there remains substantial leeway in the choice of models. That makes it difficult to compare results at different banks and harms the transparency of the stress tests.*

The **full text of the study** can be downloaded from the ECON Financial Supervision website:
http://www.europarl.europa.eu/committees/en/econ/publications.html?id=ECON00008#menuzone

16 October 2014 Authors: Marcel Magnus, Jockum Backman, contact: egov@ep.europa.eu PE 528.764

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One of the two studies was carried out by **Sascha Steffen**, European School of Management and Technology. Some of his **key findings** are outlined below (see flip page for the results of the second study):

Overall, Steffen is rather sceptical about the value of the stress test exercise, although he points out that the ***ECB's assessment*** *of the banks was very much* ***necessary*** *to evaluate the financial soundness of the banks which it will supervise from November 2014 onwards.*

Steffen hopes that the ECB's assessment will force banks to ***clean up their balance sheets****, in particular in view of the fact that the national supervisors' incentives to impose a clean-up are different and more subject to an inherent conflict of interest.*

As the ECB wants to preserve its ***credibility*** *as a central bank and to establish its authority as a supervisor at the implementation of the SSM, a serious comprehensive assessment was therefore imperative to identify and repair existing capital shortfalls within the banking sector to facilitate efficient capital flows, restore credit, and reignite economic growth in the Eurozone.*

However, Steffen points out that the ECB also faces a ***trade-off****: On the one hand, it wants to maintain its reputation as a central bank and build its reputation as a regulator from the start, on the other hand, there is the potential for capital shortfalls that require adequate backstops should any of the banks falter.*

Steffen lists a number of ***weaknesses in the design of the stress test*** *which limit the validity of its findings, among those the fact that the ECB assesses the risk exposures of banks on an individual level, not on a banking system level, and the fact that feedback effects are not accounted for although it is precisely those linkages that might increase the default risk of banks even though they seem to be well capitalized individually.*

Steffen therefore thinks that it may be advantageous to use ***benchmark models*** *against which one can evaluate the outcomes of regulatory assessments, and suggests market-based stress scenarios that can be used to predict possible stress in access to wholesale funding.*

In his research paper, Steffen therefore describes an ***alternative stress test model*** *that relies on public data and accounts for systemic risk. That model has generated results consistent with economic developments in 2010 and 2011 and provides interesting results using the sample of the banks that take part in the ECB's 2014 comprehensive assessment.*

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