European Parliament

BRIEFING

# EBA stress test 2016: Some methodological issues raised in the public domain

*This note is prepared in advance of the regular hearing with the Chair of the Single Supervisory Mechanism on 9 November 2016 in the competent Committee of the European Parliament. It deals specifically with some methodological issues raised in the public domain[1] in the context of the EBA 2016 stress test. A separate briefing on more general aspects of this exercise ("Bank stress testing: stock taking and challenges") has been published by EGOV on 22 September 2016.*

## Common methodology and disclosure

In 2016, the European Banking Agency (EBA) carried out another EU-wide stress test exercise on a sample of 51 banks from 15 EU and EEA countries. All banks in the sample had to apply the same Common Methodology that EBA published on 24 February 2016.

EBA published the final results on 29 July 2016 both in form of an aggregate Report as well as on a bank-by-bank basis, using a uniform disclosure template.

The individual disclosure templates contain, for example, information on each bank's capital position (CET1 and Tier 1), the impact of the baseline scenario and the adverse scenario on the capital ratio and leverage ratio, information on risk exposure amounts for credit risk, market risk and operational risk, as well as on sovereign holdings. The level of granularity of the data disclosed is consistent with that of previous exercises. Banks' individual results are preceded by a summary page.

## Roles and responsibilities

The EU-wide stress test involved a close cooperation in particular between EBA, national competent authorities and the ECB/SSM. Those institutions, however, had different roles:

EBA was responsible for

- developing the Common Methodology
- coordination of the exercise
- final dissemination of the results

Competent authorities, including the SSM, were responsible for

- conveying the instructions on how to complete the exercise
- ensuring the correct application of the Common Methodology
- all required follow-up measures

[1] See, for example, the article by L. Noonan, C. Binham and J. Shotter in the Financial Times on 10 October 2016, and references by Reuters and in The Irish Times and New York Post.

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### The treatment of non-recurring expenses ("one-off adjustments")

As part of the stress test exercise, banks had to make projections about their future financial situation and had to make estimates about the development of their income and expenses.

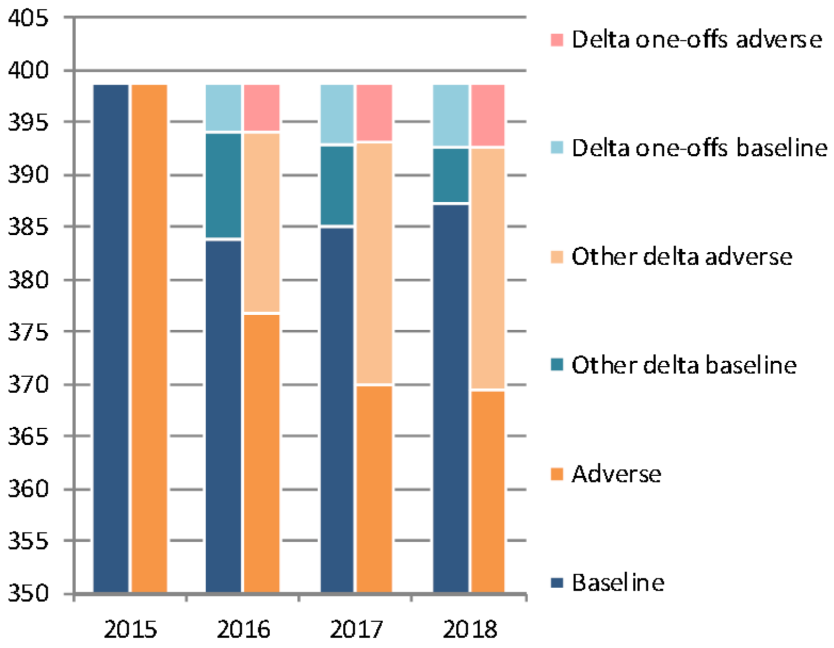
In that context, the Common Methodology sets out in point 396 that in general "*Administrative expenses and other operating expenses shall be projected by bank-internal models, but cannot fall below the value observed in 2015*."

Under certain strict conditions, however, banks were allowed to make adjustments to the level of administrative and operating expenses observed in 2015: Competent supervisors could approve so-called "one-off adjustments" if banks had provided uncontroversial evidence that some parts of their expenses would surely not recur. Such approval could only be given after a thorough quality check, and only if the eligibility requirements set out in point 397 of the Common Methodology were met.

For example, future cost reductions due to the divestment of a business unit were in principle eligible for consideration, but only if the divestment had fully taken place in the course of 2015.

Overall, 21 banks adjusted their cost projections based on approved one-off events in 2015. EBA's aggregate Report sets out that those adjustments reduced the applicable cost basis by EUR 17 billion (total amount over three years) in the baseline and EUR 16 billion in the adverse scenario; one-off adjustments hence accounted for approximately one fifth of the total projected cost reductions (see "Delta one-off" in figure 1); other elements, in particular the projected reduction of variable compensation, had a much stronger impact on the calculation (see "Other delta" in figure 1). The individual impacts from those one-off adjustments are shown in the banks' individual disclosure templates.

**Figure 1:** Aggregate reduction by approved one-off costs on the development of administrative and other operating expenses.




Source: EBA report "2016 EU-wide stress test results", published on 29 July 2016, p. 32

## A single case of a "qualifying remark"

Among all 51 individual results, there is only one disclosure template that contains an additional "qualifying remark", namely that of Deutsche Bank.

The remark, which appears three times in the bank's individual results (see picture 1) and once in EBA's aggregate report, reads: **"*The results include the sale of the stake in the Chinese legal entity HuaXia [sic], which was agreed on 28 December 2015 and will be closed in 2016.*"**

However, in EBA's documents there is no information as to the impact that the supposed sale has on the results.

**Picture 1: Qualifying remark on the summary page of [Deutsche Bank's disclosure template]**

**2016 EU-wide Stress Test: Summary**

Deutsche Bank AG

| (mln EUR, %) | Actual (starting year) 31/12/2015 | Baseline Scenario 31/12/2018 | Adverse Scenario 31/12/2018 |
|---|---|---|---|
| Cumulative 3y: Net interest income | | 41,797.05 | 41,797.05 |
| Cumulative 3y: Gains or (-) losses on financial assets and liabilities held for trading or designated at fair value through profit and loss, net | | 11,323.25 | 3,041.29 |
| Cumulative 3y: (Impairment or (-) reversal of impairment on financial assets not measured at fair value through profit or loss) | | -5,278.98 | -7,932.75 |
| Cumulative 3y: Profit or (-) loss for the year | | **7,631.70** | **-2,942.97** |
| Coverage ratio - Default stock | 44.81% | 33.54% | 34.85% |
| Common Equity Tier 1 capital | 52,429.45 | 49,253.15 | 36,638.10 |
| Total Risk exposure amount | 397,471.45 | 407,563.33 | 469,990.36 |
| **Common Equity Tier 1 ratio, %** | **13.2%** | **12.1%** | **7.8%** |
| **Fully loaded Common Equity Tier 1 ratio, %** | **11.1%** | **12.1%** | **7.8%** |
| Tier 1 capital | 58,222.30 | 58,890.60 | 46,275.55 |
| Total leverage ratio exposures | 1,398,844.00 | 1,398,844.00 | 1,398,844.00 |
| **Leverage ratio, %** | **4.2%** | **4.2%** | **3.3%** |
| **Fully loaded leverage ratio, %** | **3.5%** | **3.9%** | **3.0%** |
| **Memorandum items** | | | |
| Total amount of instruments with mandatory conversion into ordinary shares upon a fixed date in the 2016 -2018 period (cumulative conversions)[1] | | | 0 |
| Total Additional Tier 1 and Tier 2 instruments eligible as regulatory capital under the CRR provisions that convert into Common Equity Tier 1 or are written down upon a trigger event[2] | | | 4,627 |
| Of which: eligible instruments whose trigger is above CET1 capital ratio in the adverse scenario[2] | | | 0 |

[1] Conversions not considered for CET1 computation

[2] Excluding instruments with mandatory conversion into ordinary shares upon a fixed date in the 2016 -2018 period

NOTE: The results include the sale of the stake in the Chinese legal entity HuaXia, which was agreed on 28 December 2015 and will be closed in 2016.

### Background

According to its [press release of 28 December 2015], Deutsche Bank agreed to sell its entire 19.99% stake in Hua Xia Bank for approximately EUR 3.2 to 3.7 billion (subject to final price adjustment at closing, and dependent on exchange rates).

Deutsche Bank furthermore stated that on a pro-forma basis, the sale would have improved the bank's CET1 capital ratio (fully loaded) as of 30 September 2015 by approximately 30 to 40bps.

Notably, the completion of the transaction is subject to customary closing conditions and regulatory approvals including that of the China Banking Regulatory Commission.

On [30 September 2016], Deutsche Bank published a message to its employees according to which the sale has not yet been completed but is expected to be finalised soon.

## Relevance

The Common Methodology sets out (point 397) which events are eligible for consideration regarding the adjustment to the level of administrative and operating expenses observed in 2015.

Point 398 of the Common Methodology sets out that other instances may be considered in exceptional cases, but that some exceptions must explicitly not be considered, in particular (second bullet point) ***"All actions that are not fully implemented by 31 December 2015.".***

The average level of capitalisation of all banks participating in the EBA stress test exercise was 12.6% (CET1 ratio, fully loaded) at the starting point in 2015, which in the adverse scenario decreased to a level of 9.2% in 2018.

In comparison, the starting point level of capitalisation of Deutsche Bank (a CET1 ratio of 11.11%) was distinctly lower, that is 149bps below the average. In the adverse scenario, Deutsche Bank's level of capitalisation decreased to 7.8% in 2018. The impact of the adverse stress scenario on the level of capitalisation was in case of Deutsche Bank slightly lower (-332bps) than in the total sample (-340bps), though one has to keep in mind that the agreed yet uncompleted sale of Hua Xia Bank (+30 to 40bps according to Deutsche Bank's press release) was factored in.

## Comparable events

Exemplary transactions not factored into banks' stress test results:

- On 16 December 2015, for example, Barclays announced that it had agreed to sell Barclays' Risk Analytics and Index Solutions to Bloomberg for approximately GBP 520 million. The effect of this transaction was estimated to result in a pro-forma increase of circa 10bps on the 30 September 2015 CET1 ratio. The completion was said to be subject to various conditions, including anti-trust approval, and expected to only occur by mid-2016.
- On 3 August 2015, HSBC had announced that it planned to sell its entire business in Brazil to Bradesco, the 4th largest bank in Brazil, for a consideration of USD 5.2 billion. The transaction, expected to increase the Group's CET1 ratio by circa 65bps, was likewise subject to regulatory approval that was in the meantime given according to HSBC's press release of 8 June 2016.

Exemplary transactions completed in 2015 and factored into banks' stress test results:

- On 18 December 2015, Banco Popolare announced that it had received the final agreement for the disposal of the majority share capital of Istituto Centrale delle Banche Popolari Italiane. That transaction had a positive impact on the bank's CET1 ratio (fully loaded) of 69bps. Being fully completed in 2015, it was included in the stress test results.
- On 11 November 2015, Societe Generale announced the disposal of its entire 20% stake in the asset management company Amundi. That transaction had a positive impact of 24 basis points on Societe Generale's CET1 ratio by the end of 2015. Being fully completed in 2015, it was included in the stress test results.