

RESEARCH / WHITEPAPER

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2014 ECB/EBA Stress Test: Reassuring Picture of the European Banking System's Health; Limited Capital is Needed

On October 26th, the European Central Bank (ECB) published the results of the Comprehensive Assessment (CA – AQR and Stress Test). Out of 100 banks, 25 failed to meet the minimum Common Equity Tier 1 (CET1) requirements – 5.5% for the adverse scenario and 8% for the baseline scenario. There are no 'national champions' or Tier 1 banks among those that failed the stress tests.

The ECB has stressed that the main goal of this exercise was to restore market confidence in the European banks and, if needed, to raise capital using private sources, as state funds would be the last resort. Several European policy makers also think the results from the CA should lead to more lending to households and the private sector, thus triggering the recovery in Europe. However, this is unlikely without other measures (e.g., quantitative easing), according to market analysts (there is a demand problem, not a supply problem). No official communication about a potential regular stress test was disclosed by the ECB or the European Banking Authority (EBA). Banks and market analysts, however, expect a regular stress test and potential changes in the ICAAP stress testing requirements.

Capital shortfall is on the low end of expectations

The combined results of the AQR and stress test show a total real capital need of approximately €7 billion.

The total capital shortfall identified during the exercise is €25 billion (the CR uses December 2013 data – static balance sheet exercise). However, approximately €15 billion have already been raised during 2014. The additional capital required is approximately €10 billion. Of this, approximately €3 billion will be coming from Greek banks, but they have a restructuring plan that removes the capital shortfall. In terms of ratings, the market consensus is that the impact of the stress tests should be limited given the positive results and that most capital has already being raised during 2013 and 2014 by banks.

Eligible measures to meet the capital shortfall are primarily limited to capital instruments

According to the ECB, the eligible measures to raise capital are limited to capital instruments:

- » Exceptional measures: asset sales and asset deductions from CET1 when they can be identified as being distinct from normal business operations.
- » Modeling changes and RWA-driven reductions are not eligible, unless they were already approved by the local regulators / NCAs.
- » The ECB may also request changes in the dividend payments or amount of retained earnings.

Next steps: capital plan and timeline to meet the capital shortfall

Banks that fail the stress test will have two weeks (by November 10) to submit 'capital plans' to the ECB detailing how their shortfalls will be covered:

- » *Baseline scenario and AQR*: six months to cover any capital shortfalls
- » *Adverse stress testing scenario*: nine months to cover any capital shortfalls

A resolution may be initiated if banks are unable to raise capital after the mandatory period. However, the market consensus is that this is unlikely given the very small amount that needs to be raised.



Collateral effects: other potential areas of enhancement at banks

In Moody's Analytics view, further investment in the following should be high on banks' agendas:

- » Risk data aggregation
- » Model management
- » Risk inventory
- » Data quality
- » Risk assessment frameworks
- » Stress testing-related processes, auditability, and workflow enhancements
- » Capital and risk-adjusted profitability management

- » RWAs allocation and benchmarking
- » Provision modeling (e.g., IFRS 9)
- » Validation
- » Model risk quantification

Regulatory reporting and standardization of the accounting rules in Europe (definition of default, calculation, and provisions/NPLs, treatment of collateral and DTAs, etc.) should also be a priority for the ECB and EBA and an area of additional improvement at banks.

Finally, some banks may see the results of the AQR as a 'free due diligence', which may accelerate potential acquisitions in Europe. Additional de-leverage and capital raises via recapitalization plans/equity issuance and consolidation of the European financial should also be expected in the medium term.

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