EUROPEAN CENTRAL BANK

BANKING SUPERVISION

Danièle NOUY
Chair of the Supervisory Board

COURTESY TRANSLATION

Mr Bernd Lucke and Mr Joachim Starbatty
Members of the European Parliament
European Parliament
60, rue Wiertz
B-1047 Brussels

Frankfurt am Main, 27 October 2016

Re: Your letter (QZ085)

Honourable Members of the European Parliament, dear Mr Lucke, dear Mr Starbatty,

Thank you for your letter, which was passed on to me by Mr Roberto Gualtieri, Chairman of the Committee on Economic and Monetary Affairs, accompanied by a cover letter dated 22 September 2016.

Your questions relate to the ECB's view with respect to the appropriateness of the European Banking Authority's (EBA's) stress test results for regulatory decisions, against the background of a recent academic paper calculating a range of potential capital shortfalls for European banks (see second part of this letter).

The 2016 EU-wide stress test included 51 banks covering 70% of total banking assets in the European Union. The aim of the exercise was to analyse how a bank's capital position would develop on the basis of end-2015 data over a period of three years until 2018, under both a baseline and an adverse scenario. The adverse scenario reflected the four systemic risks that were considered by the European Systemic Risk Board (ESRB) to constitute the most material threats to the stability of the EU banking sector. In terms of the severity of, for example, the decrease in nominal GDP, it was comparable with other international exercises, including the US Comprehensive Capital Analysis and Review (CCAR). Furthermore, the EBA stress test methodology is prudent in its concept and across all risk types. In particular, the exercise imposes a static balance sheet – a prudent restriction which would not ordinarily be observed in an actual stress event since banks would aim to take management actions to counter it. Compared with the 2014 Comprehensive Assessment, the methodology has been further strengthened – for example by introducing an idiosyncratic shock to banks' cost of funding and by increasing haircuts for some assets classes contributing to market risk. The results, which were submitted to a thorough quality assurance review, are in my view highly relevant from a supervisory perspective and an important input for the overall 2016 Supervisory Review and Evaluation Process (SREP), which we will finalise later this year. Unlike in the 2014 exercise, no capital thresholds were defined for the purpose of the stress test. It also needs to be emphasised that the supervisory capital demand will not be computed mechanistically from the stress test results. Rather, it will be determined taking into account a wide range of information and data, such as the specific risk profile of the individual institution and its sensitivity to the stress scenarios, interim changes in its risk profile after the

cut-off date of the stress test (31 December 2015) and measures taken by the bank to mitigate risk sensitivities, such as relevant asset sales.

As mentioned in your letter, a recent study[1] by professors Viral V. Acharya (NYU, NBER and CEPR), Diane Pierret (University of Lausanne) and Sascha Steffen (University of Mannheim and ZEW), (hereinafter referred to as APS) computed a range of potential capital shortfalls for the 51 banks participating in the EBA stress test. APS derived shortfall figures using three different approaches.

1. APS calculate a €5.6 billion shortfall by applying the capital threshold of the 2014 EBA stress test to the 2016 EBA stress test results.
2. APS obtain a €123 billion shortfall by applying the thresholds on capital and leverage ratios of the 2016 US CCAR to the 2016 EBA stress test results.
3. APS estimate a €640 billion shortfall for 34 publicly listed banks participating in the 2016 EBA stress test by simulating the impact of a global stock market decline of 40% on banks' market capitalisation.

Shortfall figures obtained by APS using the first approach, taken in isolation, do not reflect the fact that supervisors determine the capital demand in the SREP not just based on the capital ratios of banks under the adverse scenario of the 2016 stress test, but also taking into account detailed information on banks' balance sheets and business models.

As regards the second and third approaches, which yield the highest capital shortfalls, I would like to make the following observations.

For the second approach, the quoted shortfall figures are driven by the assumption of a 4% minimum leverage ratio. This assumption is currently unwarranted, as leverage ratio requirements have not yet been finalised for EU banks. As a point of reference, the Basel Committee on Banking Supervision agreed to a global minimum (book) leverage ratio of 3% for all banks not categorised as global systemically important institutions (G-SIBs).

Concerning the third approach, the €640 billion shortfall estimate by APS is based on the assumption of a global stock market decline of 40% over six months, which is different from the adverse macro-financial scenario[2] used in the 2016 EU-wide stress test. The figures are further distorted by the fact that APS did not use as a basis banks' capital ratios as defined by the Capital Requirements Regulation and Directive, instead they used a variant based on market capitalisation.

In conclusion, the approaches followed by APS would not provide a valid and reliable indication of the supervisory capital demand or of any potential shortfall in the relevant ratios.

Yours sincerely,

[signed]

Danièle Nouy

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1 V. Acharya, D. Pierret and S. Steffen (2016): Introducing the "Leverage Ratio" in Assessing the Capital Adequacy of European Banks, Working Paper

2 http://www.eba.europa.eu/documents/10180/1383302/ 2016+EU-wide+stress+test-Adverse+macro-financial+scenario.pdf