2018 EBA Stress Test Shows Increased Level of Resilience of Major European Banks

The results of the 2018 EBA stress test exercise show an increased level of resilience within the major banking groups in Europe. The CET1 ratio for all banks was above 5.5% in the adverse scenario.

Key Highlights:

- Transitional and fully-loaded CET1 ratio above 5.5% in all cases for all 48 banks included in the stress tests.
- Banks reached better CET1 ratios than in 2016, despite a generally tougher adverse scenario. However, some banks might enhance their capital ratios driven by higher supervisory expectations.
- Higher capital depletion in Germany, UK and Ireland.

DBRS Ratings Limited (DBRS) considers that the 2018 European Banking Authority (EBA) stress test results show, on aggregate, an increased level of resilience for the major banking groups in Europe under a severe stress. The average transitional and fully-loaded Common Equity Tier 1 (CET1) ratios for the European Banks under the adverse scenario in 2020 came out at 10.3% and 10.1% respectively.

While the results show an increased level of resilience for the major banking groups in Europe under a severe stress, and all banks maintained a CET1 ratio above 5.5%, the results might lead some European banks to enhance their capital position in coming years.

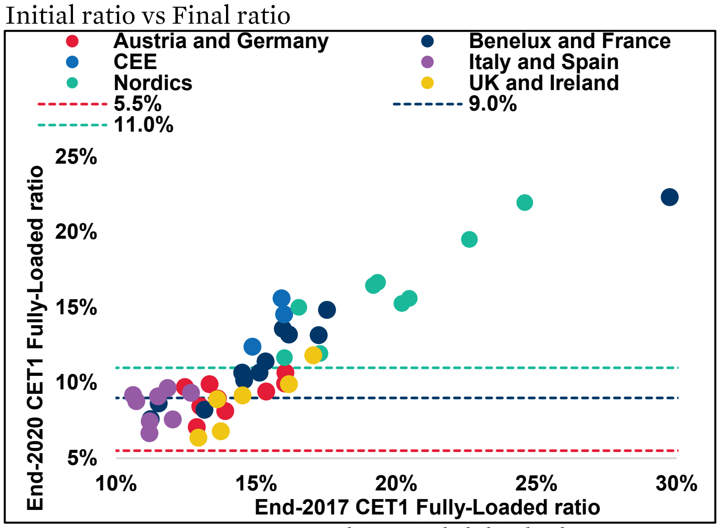
Transitional and fully-loaded CET1 ratio above 5.5% in all cases

DBRS notes that in the 2018 EBA Stress Tests all 48 banks reached a fully-loaded CET1 capital ratio above 5.5% (Exhibit 1). Similar to the 2016 exercise, there was no official pass/fail threshold, however, the 5.5% level has been widely used by market participants as an unofficial hurdle rate for the tests since it was used as such in the 2014 Stress Test results. On November 5, 2018, Luis de Guindos, Vice President of the ECB, also discussed two additional benchmarks to have a better overview of the results. According to de Guindos, whilst banks with fully-loaded CET1 ratios higher than 11% and 9% display a "strong" and "reasonable" degree of resilience to the adverse scenario in 2020, banks with the ratio falling below 9% show a "weaker, though still satisfactory, capital position". In Europe there were 14 banks (12 of which are in the Euro Area) with capital ratios below 9% in the Stress Test (Exhibit 1). DBRS does not exclude that some of them will be required to enhance their capital ratios driven by higher supervisory expectations.

Banks reached higher CET1 ratios despite tougher adverse scenario

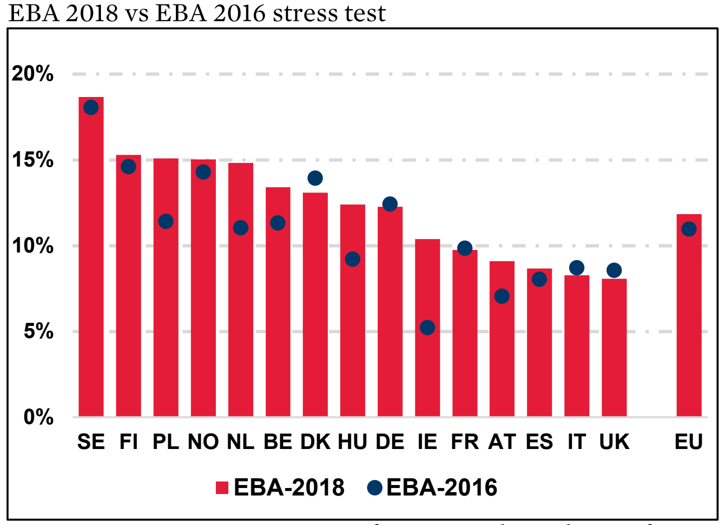
Despite a generally tougher adverse scenario than the one in the 2016 Stress Tests, the 2018 results reflect a sounder capital position for most European banks, with specific variations among individual banks and jurisdictions. This reflects stronger capital levels, combined with a similar capital depletion in both the 2016 and the 2018 exercises. Overall, the average fully-loaded CET1 ratio in the 2018 EBA Stress Test results under the adverse scenario was about 87 bps higher compared to the previous exercise (Exhibit 2). However, DBRS does caution that the adverse macroeconomic scenario differs depending on the country. In addition, results also reflect the parameters of the internal risk models used by banks, which translates economic conditions into estimated losses (see: 2018 European Stress Test: What to Expect).

Exhibit 1. Fully-Loaded CET1 ratios (Adverse scenario)
Initial ratio vs Final ratio



Source: EBA, DBRS. Notes: NRW Bank is not included in the chart.

Exhibit 2. Fully-Loaded CET1 ratios (Adverse scenario)
EBA 2018 vs EBA 2016 stress test



Source: EBA, DBRS. Notes: See Annex 3 for country code. Final ratios after a 3-year stress period.

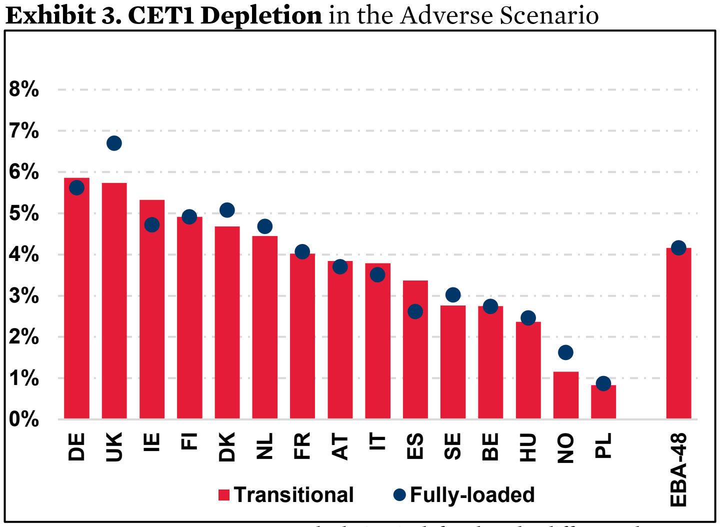
Capital Depletion higher in Germany, UK and Ireland.

The average capital depletion was around 400 bps for the sample of banks included in the exercises (Exhibit 3). DBRS notes that several factors are behind the stress test capital depletion:

1**) Income before provisioning and taxes (IBPT):** This is driven mainly by the evolution of net interest income (NII). Countries like the UK, Ireland, Austria and France show a cumulative IBPT generation over the 3-year stress period of less than 3% of RWAs (Exhibit 4). While, German and Finish banks show on average negative IBPT generation.
2) Impairment Losses: This is the main negative factor behind the capital depletion reflected in the stress test results, with an average of credit risk losses of 433 bps (Exhibit 5). According to DBRS calculations, on average, around 50% of the credit losses are related to Corporate loans, 25% to mortgage loans and another 25% to other retail loans, mainly consumer lending (Exhibit 6). The Stress Test results show again a significant diversity of outcomes depending on the jurisdiction of the bank.
3) Market Risk Losses: The EBA sample shows an average of 89 bps of market risk losses (Exhibit 5). Banks in Germany show a higher impact reflecting in part a relatively higher amount of Level 2 and 3 assets.
4) RWAs: The EBA sample shows an average impact of 170 bps in their capital ratios because of increased risk weighted assets (RWAs). Countries with low RWA density such as Sweden, Netherlands, Denmark or UK are the most affected (Exhibit 5).
5) Other: In addition, other residual factors like transitional adjustments or dividend distribution also had an impact.

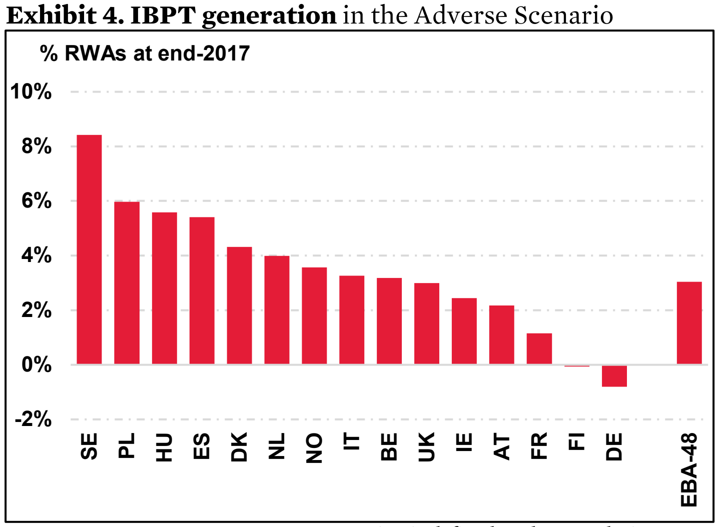
As a result, countries like Germany, United Kingdom and Ireland showed a higher capital depletion with a reduction of their average CET1 ratios of more than 500 bps. On average, German banks were mainly affected by low IBPT performance, whereas UK and Irish banks suffered, on average, from high impairments combined with modest pre-provision profit.

Exhibit 3. CET1 Depletion in the Adverse Scenario



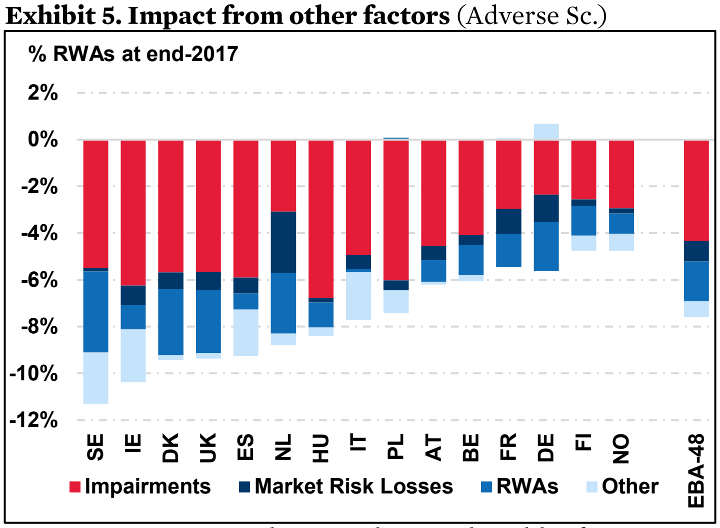
Source: EBA, DBRS. Notes: CET1 depletion is defined as the difference between the ratio at the end-2017 versus and the ratio at end-2020.

Exhibit 4. IBPT generation in the Adverse Scenario



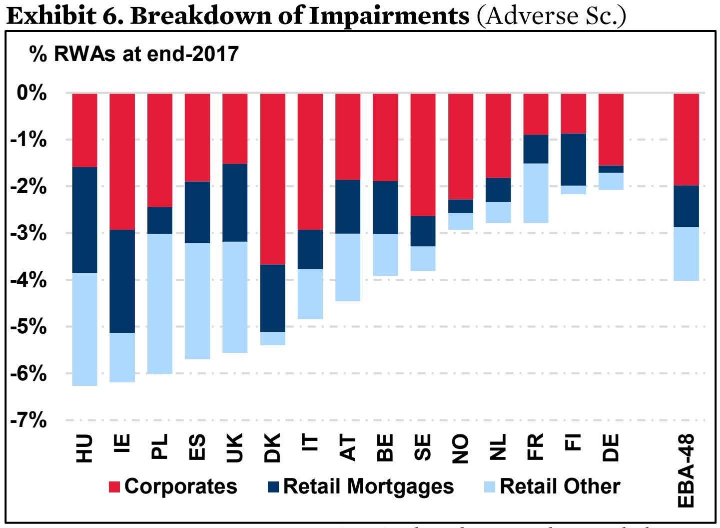
Source: EBA, DBRS. Notes: IBPT generation is defined as the cumulative pre-provisioning profit between end-2017 and end-2020.

Exhibit 5. Impact from other factors (Adverse Sc.)



Source: EBA, DBRS. Notes: The main outlier in market risk loss for NL is BNG, Excluding BNG, the average market risk loss for NL is 93 bps.

Exhibit 6. Breakdown of Impairments (Adverse Sc.)



Source: EBA, DBRS. Notes: DBRS estimation based on EBA data. Includes IRB and standardised portfolios.

High Supervisory Expectations for some Banks in the Euro-Zone

The stress test results are important in fostering transparency and market discipline. In addition, for the 33 Euro Area institutions, these stress tests have a direct supervisory implication. For banks outside the Euro Area, many are subject to additional stress tests, conducted by national authorities. These national stress testing exercises are then used to determine capital requirements and supervisory expectations.

The main supervisory implication resulting from the EBA stress test could be the potential increase of capital requirements and supervisory expectations, in the form of Pillar 2 Guidance (P2G). The implications could be potentially higher for countries with high capital depletion in the adverse scenario. In particular, the CET1 ratio depletion in the adverse scenario will be the starting point for determining the P2G. After that, the supervisor will make some adjustments, some of which are unknown.

It is worth mentioning that the P2G is not a legal binding requirement but a supervisory expectation, as part of the Total Capital Demand (TCD) of European banks (Annex 2). TCD will be not disclosed by the banks and will remain confidential. For more information please see 2018 European Stress Test: What to Expect and A Quick Guide to 2018 European Bank Capital Requirements - TSCR, OCR, TCD, MDA.

Exhibit 4: Banks participating in the EBA 2018 stress test

Country	Number of Banks	Name of the Banks
Austria	2	Erste Group Bank AG, **Raiffeisen Bank International AG**
Belgium	2	Belfius Banque SA, **KBC Group NV**
Denmark	3	Jyske Bank, **Nykredit Realkredit**, Danske Bank A/S
Finland	2	Nordea Bank AB (publ), **OP Financial group**
France	6	Crédit Mutuel Group, **BNP Paribas SA**, Société Générale SA, **Crédit Agricole Group**, Groupe BPCE, **La Banque Postale, SA**
Germany	8	Landesbank Hessen-Thüringen Girozentrale, **NRW.Bank** , Deutsche Bank AG, **DZ BANK AG Deutsche Zentral-Genossenschaftsbank**, NORD/LB Norddeutsche Landesbank Girozentrale, **Landesbank Baden-Württemberg**, Bayerische Landesbank, **Commerzbank AG**
Hungary	1	OTP Bank Nyrt.
Ireland	2	Bank of Ireland Group Plc, **Allied Irish Banks, Plc**
Italy	4	UniCredit SpA, **Intesa Sanpaolo SpA**, Banco BPM SpA, **Unione di Banche Italiane SpA**
Netherlands	4	NV Bank Nederlandse Gemeenten, **ING Groep N.V.**, Coöperatieve Rabobank U.A., **ABN AMRO Group NV**
Norway	1	DNB Bank ASA
Poland	2	Powszechna Kasa Oszczędności Bank Polski SA, **Bank Polska Kasa Opieki SA**
Spain	4	Banco Bilbao Vizcaya Argentaria, SA**, Banco Santander, SA**, CaixaBank, SA, **Banco de Sabadell, SA**
Sweden	3	Swedbank AB (publ), **Skandinaviska Enskilda Banken AB (publ.)**, Svenska Handelsbanken AB (publ)
United Kingdom	4	Barclays Plc, **Royal Bank of Scotland Group Plc**, HSBC Holdings Plc, **Lloyds Banking Group Plc**
Total	48	

Notes: Nordea is accounted as SE in the charts.

Annex 1: Data Sources and DBRS calculations

Data is taking from the EBA 2018 EU-Wide Stress Test. The figures are calculated using a simple average from the sample of banks included in the exercise (Exhibit 4). When comparing with the EBA 2016 EU-Wide Stress Test, DBRS uses only banks that participated in the 2018 exercise (excluding banks like Bankia or Banca Monte dei Paschi di Siena).

The EBA 2018 EU-Wide Stress Test uses a static balance sheet assumption. For this reason, capital actions taken after year-end 2017 as well as any losses realised during the projection years do not affect the stress test results, neither other de-risking measures taken after the reference date.

Annex 2: European Regulatory Capital Requirements

Total SREP Capital Requirement (TSCR): The TSCR is a binding requirement that Banks need to meet at all times and therefore it is the benchmark for the adverse scenario in the EBA stress test. If capital ratios fall below the TSCR, the supervisory authorities can apply different measures, including Early Intervention Measures (EIM), Maximum Distributable Amount (MDA) limitations and even the determination of Failing Or Likely to Fail (FOLF) classification that places a Bank into resolution or under insolvency proceedings. The TSCR is the sum of minimum own funds requirements (Pillar 1R) and additional own funds requirements (the so-called Pillar 2R). For 2018, the Single Supervisory Mechanism (SSM) has published that, on average, the main Banks in Europe will be required to meet a TSCR of around 10%.

Overall Capital Requirement (OCR): OCR is a binding requirement, made of the TSCR plus the Combined Buffers, that Banks need to meet during the economic cycle. The OCR is used as the benchmark for the baseline scenario in the EBA stress test as the supervisor assumes that in adverse circumstances Banks' own funds may fall below the OCR. Importantly, in that event the SSM will not reach a determination of Failing or Likely to Fail (FOLF) for capital purposes. However, breaching the OCR will trigger the MDA limitations and may imply Early Intervention Measures (EIM). The Combined Buffers are calculated as the sum of: i) Capital Conservation Buffer, ii) Systemic Buffer and iii) Countercyclical Capital Buffer. For 2018, the SSM has published that on average the main Banks in Europe will be required to reach an OCR of around 12%.

Total Capital Demand (TCD): The TCD is not a binding requirement, but a supervisory expectation. It is the combination of the OCR plus the Pillar 2 Guidance (P2G). If a Bank does not meet its TCD, this will not result in automatic action from the supervisor and will not be used as an MDA trigger, but will activate monitoring and heighted supervisory attention.

Annex 3: European Countries Codes

Long-Name	Short-Name	Long-Name	Short-Name	Long-Name	Short-Name
Austria	AT	Finland	FI	Malta	MT
Belgium	BE	France	FR	Netherlands	NL
Bulgaria	BG	Germany	DE	Poland	PL
Croatia	HR	Greece	GR	Portugal	PT
Cyprus	CY	Hungary	HU	Romania	RO
Czech Republic	CZ	Ireland	IE	Slovakia	SK
Denmark	DK	Italy	IT	Slovenia	SI
Estonia	EE	Latvia	LV	Spain	ES
Euro area	EA	Lithuania	LT	Sweden	SE
European Union	EU	Luxembourg	LU	United Kingdom	UK

Pablo Manzano, CFA
Vice President,
Global FIG
PManzano@dbrs.com

Antonio Rendina
Financial Analyst,
Global FIG
ARendina@dbrs.com

Ross Abercromby
Managing Director,
Global FIG
RAbercromby@dbrs.com

Elisabeth Rudman
Managing Director,
Head of EU FIG, Global FIG
ERudman@dbrs.com