EBA European Banking Authority

European System of Financial Supervision

9 June, 2011

2011 EU-Wide Stress Test:

Methodological Note - Additional guidance

Introduction

1. The European Banking Authority is conducting an EU-wide stress test in 2011 based on the methodology published on 18 March 2011[1]. The EU wide stress test is an important supervisory tool to assess the resilience of European banks to severe shocks and to establish a common, conservative stress testing benchmark for European banks.

2. The objective of publishing the methodology was to ensure that the stress test was applied in a consistent and conservative manner across all 90 banks[2] to identify remaining pockets of vulnerabilities in the EU banking sector and inform policymakers to ensure appropriate measures are taken to address deficiencies.

3. Key features and enhancements for the stress test for 2011 include:

   - a new consistent capital benchmark of 5% Core Tier 1 capital;

   - clear assumptions and definitions to ensure consistency, combined with a common baseline and adverse scenario developed by the ECB and European Commission; and

   - the process also includes a quality assurance process carried out by EBA staff assisted by a team of national experts who are reviewing and challenging bank results insisting on changes as necessary.

Quality assurance process

4. An important element of the stress test is that it is applied consistently. Preliminary (first-round) results have been submitted to the EBA and are now subject to the quality assurance process of the EBA. This is a key element of the process where the EBA staff, assisted by a team of national and ECB/ESRB experts, scrutinise and challenge the results of banks. The preliminary results are assessed to ensure the methodology has been implemented in a conservative and consistent fashion and are assessed against a series of benchmarks, including historical experience, the experience of other banks in the sample and top down analysis undertaken by the EBA and ESRB with ECB assistance.

5. The main component of the quality assurance process is bilateral engagement between the EBA, national supervisory authorities and individual banks to explain, clarify and address possible inconsistencies or errors in the results submitted. The EBA staff may also highlight areas where assumptions have been employed which appear optimistic or out of line with expectations and in the absence of compelling evidence to the contrary will expect the results to be changed accordingly.

6. In addition there a small number of areas where a number of banks appear to have used approaches that are either inconsistent with the methodology, and the objectives it was trying to achieve, or where further clarity has been

[1] See: http://www.eba.europa.eu/cebs/media/Publications/Other%20Publications/2011%20EU-wide%20stress%20test/EBA-ST-2011-004-%28Detailed-Methodological-Note%29_1.pdf

[2] The sample of banks has been reduced from 91 to 90 on 14 July 2010.

requested from the EBA. The purpose of this additional guidance to address those thematic issues and provide further guidance on how to address them across the sample. It should not be seen as a substitute for the ongoing bi-lateral engagement between the EBA Quality assurance task force and national supervisory authorities and individual banks. Nor does it seek to change the published methodology.

7. The main areas addressed in this note include the following:

   Benchmarks:

   - the treatment of sovereign and financial institution exposure in the banking book;
   - the treatment of the cost of funding, with a particular focus on the cost of official funding and retail funding;
   - haircuts to sovereign exposures in the trading book where market developments have overtaken the original scenario;
   - the treatment of interest income in the trading book; and
   - the treatment of trading book RWAs in the context of the introduction CRD 3.

   Re-statements and clarification of the existing methodology:

   - the use of a 5 year historical average to determine trading income;
   - the treatment of administration costs;
   - the treatment of exemptions from the static balance sheet assumption and the disclosure of business decisions that have been taken in 2011; and
   - the use of collective provisions and reserves

How to use this guidance

8. The guidance has been designed as a result of the quality assurance and peer review process. The objective of the further guidance is to provide a neutral and consistent tool with which the EBA and national supervisory authorities can challenge the results of all banks in the sample in the clear knowledge that there is a level playing field in the challenge process.

9. Benchmarks are designed to provide some certainty where there are wide divergences in outcomes which are not obviously attributable to fundamental differences in banks portfolios. They are expected to be used as a floor with no exceptions to (i) the floor set on the treatment of sovereign and financial institution exposure in the banking book (ii) the suggested floor to official funding costs. It is possible that there would be exceptions to the other benchmarks, which may arise in a very few circumstances if there are clear and compelling reasons why. For example if deposits legally do not carry

interest rates then there may be some adaption to the overall approach to the retail cost of funding.

10. The re-statements and clarifications to the existing methodology should be treated as clarification to the original methodology and are expected to be applied in the same way as their treatment in the original methodology.

BENCHMARKS

BENCHMARK 1 – The treatment of sovereign and financial institution exposure in the banking book

11. The EBA Board of Supervisors decided clearly that the market risk haircuts to the value of sovereign exposures would not apply to exposures held in the banking book. However, as with any other credit risk held in the banking book, fundamental credit analysis is expected to be undertaken and banks are expected to assess the impact of the scenarios on sovereign debt in the banking book based on movements in PDs and LGDs.

12. IRB banks calculate their regular risk parameters for sovereign exposures in the banking leading to both Expected Loss (EL) and Unexpected Loss (UL) calculations. Standardised banks rely on credit ratings to determine regulatory capital (i.e. UL) which is anyway zero regardless of the rating if it is to a domestic government in domestic currency. However, both IRB and standardised approach banks should be considering their provisions for such losses, based on EL.

13. The EBA has made comparisons across the banks and found that some banks have already made prudent safeguards against sovereign debt and have non-zero PDs for such holdings, resulting in the calculation of expected losses (PD x LGD x EAD) and allocation of provisions for such losses. However, other banks have PDs at zero for UL and EL and subsequently hold no provisions. Similarly the initial analysis of the results for financial institutions portfolio, shows they have been treated differently across banks and in many cases the impact is negligible with zero PDs.

14. Recent heightened concerns in the sovereign debt market suggest such low PDs are inappropriate in some cases and there is increasing pressure to factor in some valuation stress to the banking book. While applying haircuts to the exposures in the banking book would not be consistent with current regulatory treatment, a consistent and conservative approach to assessing sovereign risk in the banking book should be followed.

Proposals for a consistent approach to sovereign and institutions' portfolios

15. Since simplicity is a desired element of any approach, a common PD and LGD should be identified as a starting point. One simple but objective way to do this is to look to publicly available data such as credit ratings. Notch downgrades can then be applied in the stress taking into account the situation as of 1 June 2011.

16. The following notch downgrades, which depend on the starting rating levels, are to be applied to the exposures vis-à-vis sovereign and institution exposures:

- AAA / Aaa no downgrading;
- AA / Aa2 to A- / A3: two notch downgrade; and

- BBB+ / Baa1 or below: four notch downgrade with a floor at CCC.

17. For simplicity this approach could focus purely on determining appropriate provisions (EL) for both IRB and TSA banks. No changes would be made to RWA from the existing submission.

Table 1. ECAI ratings of the EU sovereigns

Rating (Long Term, Foreign Currency) and Outlook						
Country	**Moody's Rating**	**Moody's Outlook**	**S&P Rating**	**S&P Outlook**	**Fitch Rating**	**Fitch Outlook**
AUSTRIA	Aaa	STABLE	AAA	STABLE	AAA	STABLE
BELGIUM	Aa1	STABLE	AA+u	NEG	AA+	NEG
BRITAIN	Aaa	STABLE	AAAu	STABLE	AAA	STABLE
BULGARIA	Baa3 *+		BBB	STABLE	BBB-	POS
CYPRUS	(P)A2 *-		A-	NEG	A-	NEG
CZECH	A1	STABLE	A	POS	A+	POS
DENMARK	Aaa	STABLE	AAA	STABLE	AAA	STABLE
FINLAND	Aaa	STABLE	AAA	STABLE	AAA	STABLE
FRANCE	Aaa	STABLE	AAAu	STABLE	AAA	STABLE
GERMANY	Aaa	STABLE	AAAu	STABLE	AAA	STABLE
GREECE	B1 *-		B *-		B+ *-	
HUNGARY	Baa3	NEG	BBB-	NEG	BBB-	NEG
ICELAND	Baa3	NEG	BBB-	NEG	BB+	STABLE
IRELAND	Baa3	NEG	BBB+	STABLE	BBB+	NEG
ITALY	Aa2	STABLE	A+u	NEG	AA-	STABLE
LATVIA	Baa3	STABLE	BB+	POS	BBB-	POS
LITHUANIA	Baa1	STABLE	BBB	STABLE	BBB	POS
LUXEMBOURG	Aaa	STABLE	AAA	STABLE	AAA	STABLE
MALTA		STABLE	A	STABLE	A+	STABLE
NETHERLANDS		STABLE	AAAu	STABLE	AAA	STABLE
NORWAY	Aaa		AAA	STABLE	AAA	STABLE
POLAND	A2	STABLE	A-	STABLE	A-	STABLE
PORTUGAL	Baa1 *-		BBB-	NEG	BBB- *-	
ROMANIA	Baa3	STABLE	BB+	STABLE	BB+	STABLE
SLOVAKIA	A1	STABLE	A+	STABLE	A+	STABLE
SLOVENIA	Aa2	STABLE	AA	NEG	AA	STABLE
SPAIN	Aa2	NEG	AA	NEG	AA+	NEG
SWEDEN	Aaa		AAA	STABLE	AAA	STABLE
Source: Bloomberg, data as of 1 June 2011						

Table 2. Considerations for average of implied PDs based on ECAI ratings

Fitch rating	Fitch Global Corporate Finance 2 years average (cumulative) default rates - 1995-2009 *	Moody's rating	Moody's Corporate 2 years average (cumulative) default rates - 1998-2010 **	Standard and Poor's rating	S&P's Global Corporate 2 years average (cumulative) default rates 1981-2010 ***	Average Implied PD ****
AAA-AA	0%	Aaa-Aa2	0.02%	AAA-AA	0.04%	0.03%
AA-	0.07%	Aa3	0.13%	AA-	0.11%	0.10%
A+	0.12%	A1	0.30%	A+	0.12%	0.18%
A	0.30%	A2	0.28%	A	0.21%	0.26%
A-	0.37%	A3	0.27%	A-	0.23%	0.29%
BBB+	0.35%	Baa1	0.45%	BBB+	0.45%	0.42%
BBB	0.80%	Baa2	0.55%	BBB	0.57%	0.64%
BBB-	1.36%	Baa3	0.98%	BBB-	1.17%	1.17%
BB+	3.34%	Ba1	1.69%	BB+	1.48%	2.17%
BB	3.73%	Ba2	1.82%	BB	2.47%	2.67%
BB-	3.13%	Ba3	3.64%	BB-	3.92%	3.56%
B+	4.55%	B1	5.78%	B+	7.00%	5.78%
B	7.38%	B2	9.13%	B-	12.62%	9.71%
B-	5.19%	B3	14.28%	B-	17.19%	12.22%
CCC-C	32.55%	Caa1-c	39.12%	CCC-C	36.79%	36.15%

* Global Corporate Finance

** Corporate Default and Recovery Rates, 1920-2010

*** 2010 Annual Global Corporate Default Study and Rating Transitions

**** EBA calculations

18. The PDs to be applied to the different rating grades are the average of the 2 years cumulative corporate default rates as a proxy, published by Fitch, Moody’s and Standard and Poor’s.

19. The LGD should be set at 40% based on the EBA’s review of banks own estimates.

20. The approach described above should lead to EL calculations for all sovereign and institutional exposures in the banking book. Additional provisions should be held to this amount. This should be built up 50% in 2011 and the additional 50% in 2012.

BENCHMARK 2 – Treatment of the cost of funding with a particular focus on the cost of official funding and retail funding

21. In the macro economic scenario provided, interest rates generally increase which according to the methodology is expected to impact both the assets and liabilities of a bank. In a number of cases the impact seems to have been interpreted in an optimistic fashion, with a substantive positive impact on interest received from loans to customers, and a very mild, often unnoticeable impact on the interest rates that banks pay for their funding.

22. In several cases the methodology outlined in the Methodological note was not implemented as expected. In particular this applies to wholesale funding and the interbank market. The EBA has identified specific anomalies and is providing a tool to allow supervisors to assess what the probable output would be. Obviously the actual impact of the methodology will vary depending on the specific situation of each bank, but such differences would not seem to justify the discrepancies seen so far. Supervisors are therefore asked to ensure that banks assure they have applied the methodology correctly and correct any divergences from Sections 5.4.4.1 and 5.4.4.2 in the Methodological note. In particular that interest rates on funding should increase according to the evolution in the macro-economic scenarios taking into account banks' own credit spreads, which are assumed to be subject to the same negative evolution as sovereign credit spreads. For cross border groups, funding costs reflect the source of funding rather than group domicile.

23. The methodology was more open on the impact of the scenario on retail funding and official funding costs. For retail funding, the Methodological note identified increased competition for retail funds as an issue and was therefore clear that any assumptions of stability in funding costs would be assessed and challenged during the quality assurance process. In a number of cases no change in retail funding costs was assumed, whereas many other institutions identified more realistic outcomes where the increased cost of retail funding was related to, and often exceeded, implied movements in official rates. Such divergences were noted across the sample and included differing assumptions within countries. To ensure consistency across the sample the EBA expects the following to be applied as a floor, as any term funding matures, in the absence of clear and specific evidence to the contrary.

- The increase in the overnight rate is expected to be applied to most retail funding.
- For sight deposits a benchmark rate would be that banks should apply half of the official financing cost increase implied in market expectations (37.5 bp – see below) and half of the increase in sovereign spreads (short end) to their sight deposits.

24. In both cases this is a benchmark which the EBA and national supervisors are invited to use as a floor to assess banks assumptions. It should be applied as a floor it in the absence of clear and specific evidence to the contrary.

25. On official funding costs, the EBA and ECB/ESRB did not feel it appropriate to be seen as forecasting monetary policy. Therefore the scenario implies, but does not explicitly specify, an increase in official financing costs in the baseline scenario. Most banks in the sample understood this and appropriately applied an associated increase in official financing costs. Others however, did not apply this and asked for further guidance. To that end the EBA is providing guidance, in no way linked to a forecast of official rates, that official funding should increase linearly by at least 75 basis points in 2011 and stay at that rate for the duration of the stress test.

26. As a final note, banks are reminded not to compute interest income on defaulted assets as these are not replaced under the static balance sheet assumption.

BENCHMARK 3 - Haircuts to sovereign exposures in the trading book where market developments have overtaken the original scenario

27. The EBA has been asked on several occasions whether the macro economic scenario would be updated to reflect developments that have occurred since its release in April. The EBA's view is that the stress test is designed to understand the impact of hypothetical changes in external circumstances on banks and that the overall scenario remains appropriately severe as a divergence from the baseline with recent forecasts[3] showing the baseline outlook has improved in a number of countries. Therefore it would be inappropriate to tweak the general macro economic scenario at this stage even if for some individual countries the outlook has deteriorated. However, the EBA is also aware that there are some elements of the stress where the impact is immediate, in particular the sovereign haircuts which would be applied to the trading book positions of banks' sovereign exposures. Moreover, there are a limited number of cases where market movements have overtaken the scenario and for the purposes of the sovereign haircuts the EBA is asking banks to adjust the impact to more fully reflect the current conjuncture. To this end banks are requested to use the Table 3 below (with changes highlighted) to replace Table 3 in Annex 4 to the Methodological note[4] and Table 4 below (with changes highlighted) to replace Table 4 in Annex 4 of the Methodological note.

[3] See: http://ec.europa.eu/economy_finance/eu/forecasts/2011_spring_forecast_en.htm
[4] See: http://www.eba.europa.eu/cebs/media/Publications/Other%20Publications/2011%20EU-wide%20stress%20test/Annex-4-Trading-book-stress-and-sovereign-haircuts.pdf

Table 3
Valuation haircuts on sovereign bonds

	Adverse scenario							of which due to widening of sovereign spreads						
Country	3M	1Y	2Y	3Y	5Y	10Y	15Y	3M	1Y	2Y	3Y	5Y	10Y	15Y
Austria	0.2%	0.5%	1.1%	1.9%	3.4%	5.5%	8.4%	0.0%	0.2%	0.3%	0.6%	1.1%	1.9%	2.9%
Belgium	0.2%	1.2%	2.1%	3.7%	5.9%	9.8%	15.3%	0.1%	0.6%	1.2%	2.2%	3.7%	6.1%	9.5%
Bulgaria	0.3%	1.1%	2.1%	3.3%	5.4%	8.7%		0.1%	0.6%	1.2%	2.0%	3.4%	5.5%	
Cyprus	0.4%	2.1%	3.4%	5.0%	7.7%	12.3%		0.2%	1.6%	2.4%	3.7%	5.8%	9.2%	
Czech Republic	0.2%	0.5%	1.2%	2.3%	3.2%	5.8%	11.1%	0.1%	0.2%	0.5%	1.0%	1.5%	2.7%	5.1%
Denmark	0.1%	0.5%	1.0%	1.6%	2.6%	6.3%	9.9%	0.0%	0.1%	0.2%	0.4%	0.7%	1.7%	2.7%
Finland	0.1%	0.4%	0.9%	1.9%	2.7%	4.2%		0.0%	0.1%	0.1%	0.3%	0.5%	0.8%	
France	0.2%	0.8%	1.6%	2.6%	4.1%	7.3%	13.1%	0.1%	0.3%	0.7%	1.3%	2.1%	3.8%	6.6%
Germany	0.1%	0.5%	0.9%	1.3%	2.1%	3.5%	6.2%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Greece	0.5%	5.1%	25.6%	29.5%	18.1%	25.2%	26.2%	0.4%	4.5%	24.6%	28.2%	16.2%	22.5%	22.1%
Hungary	0.2%	0.9%	1.8%	2.9%	5.1%	8.0%		0.2%	0.9%	1.7%	2.7%	4.8%	7.5%	
Ireland	0.9%	3.8%	12.7%	16.9%	19.4%	19.1%	22.7%	0.8%	3.4%	11.7%	15.7%	17.4%	16.0%	18.9%
Italy	0.3%	1.5%	3.0%	5.0%	8.4%	13.1%	20.1%	0.2%	1.0%	2.1%	3.7%	6.3%	9.7%	14.7%
Latvia	0.2%	0.8%	1.8%	2.8%	4.3%			0.1%	0.4%	0.9%	1.5%	2.3%		
Lithuania	0.2%	1.2%	1.8%	3.1%	4.8%			0.1%	0.6%	0.9%	1.8%	2.8%		
Luxembourg				3.1%	5.6%	9.3%					1.9%	3.5%	5.8%	
Malta	0.3%	1.3%	2.6%	4.8%	7.4%	13.2%		0.2%	0.9%	1.8%	3.5%	5.5%	9.8%	
Netherlands	0.1%	0.6%	1.2%	2.1%	3.2%	5.2%	9.5%	0.0%	0.2%	0.4%	0.7%	1.1%	1.7%	3.1%
Poland	0.1%	0.6%	1.2%	1.7%	2.8%	5.0%	7.7%	0.1%	0.6%	1.2%	1.7%	2.8%	5.0%	7.6%
Portugal	0.5%	6.4%	12.6%	18.9%	21.7%	22.3%	33.2%	0.4%	5.8%	11.7%	17.5%	19.8%	19.0%	27.5%
Romania	0.3%	1.0%	2.0%	3.4%		8.7%		0.2%	0.6%	1.3%	2.2%		5.8%	
Slovakia	0.2%	0.8%	1.4%	2.2%	3.5%	5.9%	8.0%	0.1%	0.3%	0.5%	0.9%	1.5%	2.5%	3.3%
Slovenia	0.2%	0.8%	1.4%	2.3%	3.7%	6.0%		0.1%	0.3%	0.6%	1.0%	1.7%	2.8%	
Spain	0.5%	1.6%	3.4%	5.5%	9.0%	14.6%	23.2%	0.3%	1.2%	2.5%	4.2%	7.0%	11.3%	17.6%
Sweden	0.1%	0.3%	0.6%	1.2%	1.9%	3.1%	6.5%	0.0%	0.0%	0.1%	0.2%	0.3%	0.5%	1.0%
United Kingdom	0.2%	1.1%	1.9%	3.1%	4.7%	7.6%	14.1%	0.0%	0.2%	0.5%	0.8%	1.3%	2.1%	3.8%
Iceland		0.3%	1.0%	1.6%	3.6%	5.2%	7.4%		0.2%	0.5%	0.8%	2.0%	2.8%	4.0%
Norway	0.1%	0.4%	0.8%	1.1%	1.5%	3.3%		0.0%	0.0%	0.1%	0.1%	0.2%	0.5%	

Note: The items highlighted in yellow were updated in the course of the exercise by the EBA and reflect recent adverse market developments up to 24 May 2011.

Source: European Banking Authority and European Central Bank.

Table 4
Adverse scenario: shocks to sovereign credit spreads, by maturity

(in basis points)

Country	3M	1Y	2Y	3Y	5Y	10Y	15Y
Austria	16	16	19	21	23	23	24
Belgium	53	53	62	70	76	78	79
Bulgaria	55	55	64	72	79	81	82
Cyprus	93	123	108	123	134	137	139
Czech Republic	24	24	28	32	34	35	36
Denmark	11	11	13	15	17	17	17
Finland	7	7	8	9	10	10	11
France	33	33	38	43	47	48	49
Germany	0	0	0	0	0	0	0
Greece	174	1396	1319	1126	386	462	318
Hungary	78	78	91	103	112	114	117
Ireland	315	312	549	586	423	258	263
Italy	93	93	108	123	134	137	139
Latvia	38	38	44	50	54	55	56
Lithuania	44	44	51	58	64	65	66
Luxembourg	53	53	62	70	76	78	79
Malta	93	93	108	123	134	137	139
Netherlands	15	15	18	20	22	22	23
Poland	46	46	53	60	66	67	68
Portugal	168	397	638	584	520	326	301
Romania	62	62	72	82	90	91	93
Slovakia	22	22	26	29	32	32	33
Slovenia	26	26	30	35	38	38	39
Spain	112	112	130	148	161	164	167
Sweden	4	4	5	5	6	6	6
United Kingdom	19	19	22	25	28	28	29
Iceland	28	28	32	37	40	41	42
Norway	4	4	5	5	6	6	6

Note: The items highlighted in yellow were updated in the course of the exercise by the EBA and reflect recent adverse market developments up to 24 May 2011.

Source: European Banking Authority and European Central Bank.

BENCHMARK 4 - The treatment of trading book RWAs in the context of the introduction CRD 3

28. Paragraph 237 of the Methodological note, asks banks to derive their respective forecast for the CRD 3 driven increase in trading book RWA. The methodology asked that banks provide internal figures or, if they were unable to, a scaling of 2010 figures is applied (Paragraph 238 of the Methodological note) which was based on historical experience from previous quantitative impact studies in 2009 and 2010 and implied a 40% increase in RWAs.

29. A large majority of model banks provided their own forecasts of CRD 3 driven increase of trading book RWA, which will enter into force in the end of 2011. The quality assurance process has discovered important differences between internal estimations and the original scaling factor which was suggested in the note. At the same time there is a high degree of consistency amongst banks which have provided their internal model estimates. Banks with

internal models that have calculated these changes estimate that the application of CRD 3 to the trading book lead to increases of RWAs, which are clustered around 300%. This is considerably greater than the increase in RWA previously estimated in QIS studies that the EBA used as the benchmark in its original Methodological note.

30. The challenge is that some banks with internal models have declined to provide their internal estimates preferring to use the scaling factor, which based on new information to the EBA, appears to be an underestimate of the likely impact.

31. This leaves the EBA with a choice. Either to ensure consistency by asking all banks to scale down the impact to a level which it knows is inappropriate. Or to act on the new information available to the EBA to achieve a level playing field by adjusting the scaling factor to more appropriately capture the likely implementation of CRD 3 in 2011.

32. The EBA views the most appropriate outcome is that banks provide their internal model estimates. This would then reflect the more appropriate outcome of capturing actual regulatory changes as they occur in the period of the stress test. However, to ensure consistency the EBA suggests applying a scaling factor of 2.5 as a floor to internal model positions, especially in those cases where a bank is unwilling or unable to provide an internal model estimate.

33. The treatment of positions using the standardised approach will remain as per the Methodological note.

BENCHMARK 5 - The treatment of interest income in the trading book

34. The Methodological note states that the trading book shock is an instantaneous shock, which means it is a one off event. The methodology also allowed banks to calculate trading income as an average of their previous 5 years. This trading income reflects gains from the trading activities of all instruments in the trading book including fixed income securities.

35. Separately, the Methodological note references interest income in the trading book in the following way "The forecast must be consistent with the volume and characteristic (typologies, yields) of the invested assets at the end of 2010 and changes in the macro-economic scenario". The EBA has identified that this has led to an inconsistency. A number of banks have included total interest income on the static balance sheet of the trading book over the whole two years, in addition to the trading income based on the historical average. This approach has the effect of reducing the impact of the shock significantly. In practice banks may not hold the bonds for such long periods and this approach ignores both trading frequency and the holdings of differing maturities by banks, which are taken into account when applying shocks to the trading book. That is short maturities receive a smaller haircut but in the results received this bonds are simply rolled over, producing interest income for the whole period. This is a particular problem for sovereign holdings.

36. National authorities are requested to check that interest income in the trading book is not included in the historical calculation of net trading income used to calculate the five year average. In addition, to ensure consistency, conservatism and neutrality, and based on a series of discussion held with national authorities involved, the EBA recognises the difficulties that excluding all interest income would pose at this stage of the process.

37. Therefore the following benchmarks should be used to determine appropriate levels of interest income on sovereign exposures in the trading book for the purposes of this stress test:

- applying a minimum of the two-year haircuts to sovereign exposures in the trading book but continuing to include their interest income for the full period on the static balance sheet; or

- use the existing sovereign haircuts, differentiated by maturity, and then including interest income in the trading book at a risk free rate (e.g. using the two-year Bund as of 01/01/2011 as a reference rate) This has the effect of replicating a forced sale at market values and reinvestment in risk free products.

RE-STATEMENTS AND CLARIFICATIONS

Clarification 1 - The use of a 5 year historical average to determine trading income

38. Paragraph 131 of the Methodological note notes that net trading income should be in line with the average profitability of the Held for Trading (HFT) portfolio in the last five years up to 2010. In most cases the EBA has seen that banks have taken an average of their net trading income. However, in some cases banks have made assumptions about rapid growth in their net trading income. For the purposes of the EBA's stress test, which is looking in a consistent fashion at negative external circumstances with a static balance sheet assumption such increases do not seem appropriate. Therefore national supervisory authorities are asked to ensure the average 5 year net trading income is used by all banks, with some very limited exceptions for example where there is clear and demonstrable proof of a change such as exemptions from the static balance sheet that have a clear and direct impact on trading income (e.g. it is now zero as a result of restructuring).

Clarification 2 – The treatment of administration costs

39. The Methodological note states that administrative costs are expected to be stable over the time horizon of the exercise. A favourable interpretation of this is that they remain flat rather than rising in line with inflation. In very exceptional circumstance costs may change in line with an exemption from the static balance sheet assumption but in general the EBA expects the administration costs to at least remain flat. A number of banks have claimed this is inappropriate because they would be reducing staff in the 2011 and 2012 or they had one off costs in 2010. The EBA notes the uncertainty about how costs would move in a downturn and that often costs actually increase. To this end the stability of administrative costs is required with the same caveats as above for average trading income.

Clarification 3 – The treatment of exemptions from the static balance sheet assumption and the disclosure of business decisions that have been taken in 2011

40. The EBA stress test runs from end 2010 to end 2012. As a result of requests from national authorities the EBA agreed to include information on specific measures already taken up to end April 2011 to assist observers in understanding the impact of such mitigating measures.

41. The EBA agreed that there should be clear principles regarding exemptions and that the EBA should stick to those principles. In particular, that the exemption should be legally binding. The EBA notes that where measures are subject to state aid rules there must be a clear agreement with the relevant EU authorities that the details of the restructuring plans are agreed. Without such agreement there is a possibility that the plans will be revised after the

publication of the stress test. The EBA has experience that revisions do take place and cast doubt on the integrity of the stress test overall. Therefore, in line with the stance agreed by national authorities, the EBA has made every effort to determine whether there is a clear and final agreement or not.

42. Many banks and supervisors have also raised the question as to whether business decisions, other than actual capital raising, can be included in the same context as mandatory restructuring plans and capital raising. As the stress test is based on a scenario that runs from 2010-2012 and is based on a static balance sheet assumption it seems inappropriate to include any business decisions from a conceptual perspective. Moreover, from a practical perspective, the EBA has received such a wide range of requests for items to be included, ranging from sales of subsidiaries to partial sales of businesses and disposals of portfolios or parts of portfolios, that it would be impossible to draw any dividing line on the materiality of business decisions. Therefore all business decisions should be included as an explanation of mitigating actions and will not be considered as mandatory restructuring plans.

Clarification 4 – The use of collective provisions and reserves

43. The Methodological note states that "banks shall demonstrate to the respective national supervisors that in consideration of the recent dynamic of expected losses observed in the last years, and expected in the next years, there is no need for increasing the stock of provisions on non defaulted assets". To that end it was expected that provisioning levels would increase during the stress test. A number of banks have identified the use of collective provisions and other reserves to absorb losses during the stress. This creates challenges in explaining how these are used from both a consistency and conservatism perspective.

44. From a consistency perspective the use of provisions should be clearly and separately disclosed if banks view that as an appropriate mitigating measure. Any hidden measures to absorb losses creates challenges in understanding the impact of the stress test consistency against the agreed benchmark of a narrow definition of capital, CT1. Rather there should be a clear link between the stress test impact and the agreed measure of loos absorbing capital, CT1.

45. In addition, from a conservatism perspective, the objective of the stress test is to assess the resilience of the EU banking sector so that it is positioned to weather further challenges. If general provisions or reserves are run down during the adverse but plausible scenario then it leaves the banking sector in a more fragile state. Moreover, a review of metrics such as coverage ratios raises concern that such metrics would look weak after the stress.

46. The EBA does not prohibit the use of such provisions and reserves but requests that they should be clearly disclosed so that their use is clearly identified as a mitigating measure. In this context it will be important that the final report draws attention to and explains those measures taken according to national regulations that have created additional reserves through P&L with a view to shelter increases in losses during a downturn.

Other issues identified in the quality assurance and peer review process

47. The issues outlined in this note are the key areas that supervisors are asked to convey to all banks in the sample. They are not however, an exhaustive list of all bilateral issues. Many such bi-lateral issues have already been raised with participating banks but it is likely that other issues will be raised. In particular, the EBA has noted variation, and at time inconsistencies, in the PDs and LGDs that banks have calculated. This is the case both for starting point parameters and their change during the stress. To this end it is noted that significant challenge and push back will be provided, particularly to outlier banks. The EBA will be requesting further evidence of the appropriate calculation of these parameters and expects to request that changes be made in a number of cases in order to bring consistency to the sample whilst still taking into account the individual risk profiles of banks in the sample.

48. The EBA's treatment of securitisation holdings in the banking book has been the subject of a number of queries. This approach is more prescriptive than other parts of the methodology and the EBA has been asked if more flexibility can be provided in this aspect. The concerns raised by banks and supervisors are clear and it will be important to communicate in the final report how this element of the stress is reached and show the impact separately in the results.