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EBA 2021 EU-Wide Stress Test

Methodological Differences for Market and Credit Risks between 2021 and 2020 Exercises

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At a Glance

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Overview

Timeline

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The 2021 timeline is the eighth with respect to the that proposed for the 2020 exercise and remains more compressed than in 2018

- ***Nov 2020*** – *Publication of the 2021 methodology (draft)*
- ***Dec 2020*** – *Publication of the 2021 final methodology*
- ***End of Jan 2021*** – *Launch of the exercise*
- ***Begin of Apr 2021*** – *First submission of results*
  - *One month early vs 2018 exercise*
- ***Mid of May 2021*** – *Second submission of results*
- ***End of Jun 2021*** – *Third submission of results*
- ***Mid of Jul 2021*** – *Final submission of results*
  - *Two months early vs 2018 exercise*
- ***End of Jul 2021*** – *Publication of results*

As already happened for the 2020 exercise, the anticipation of some of the deadlines with respect to the 2018 timeline might represent a challenge for banks

The reduction of the time to get ready for the submission of the results represents a challenge and there is the need to test The stream lined process. In order to anticipate this necessity banks should: **process for conducting the exercise and the governance for decision making in order to ensure a fluid and**

- Identify any relevant positions that drive significant **impact on CET 1** under the stress scenario
- Test any relevant **methodological enhancement** in order estimate in advance the impact on the bank's portfolio
- Perform a **test of the overall process** for conducting the exercise

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Overview

Credit Risk

Banks are required to forecast **credit impairments** resulting from the realization of two separate macroeconomic scenarios (Baseline and Adverse) within **IFRS9** accounting principles' framework. The estimation of credit impairments requires the use of **statistical methods** and includes the following main steps:

- estimating starting values of the risk parameters;
- estimating the impact of the scenarios on the risk parameters;
- computing **changes in the stock of provisions** that will drive the P&L impact

Scope

P&L impact	RWA amount
all counterparties and all positions exposed to risks stemming from the default of a counterparty, except for exposures subject to CCR and fair value positions which are subject to the market risk approach	exposures subject to CCR and fair value positions included

The big change in the world has been of course the **SARS COV 2** pandemic spread and the consequent economic recession reflected in the steep drop of nations' GDPs.
European nations introduced several mitigation measures to sustain citizens and enterprises.
Within banking system, **moratoria** and **government guarantees** have been setup in order to temporarily unburden the pressure of loans' repayments on borrowers and mitigate the increase of ECL for banks.
EBA's changes in Credit Risk methodology are meant to handle both the recession due **to the SARS COV 2 pandemic spread and the mitigation actions introduced by the Governments**

Overview

Market Risk

The aim of the EBA EU-wide Stress Test is to assess the resilience of EU Banks to adverse market developments

The methodology regarding Market Risk can be summarized as follows:

- The impact of market risk on all positions at partial or full fair value measurement is to be assessed through **full revaluation**
- The full revaluation is performed after the **application of the shocks**, that are provided from the EBA in the **market risk adverse scenario**, to a common set of market risk factors
- Under the **trading exemption**, Banks are allowed to not apply a full revaluation on items held with a trading intent and their related hedges. Banks under this exemption have the possibility to adopt a simplified set of rules that are based on a sensitivity approach
- After the full revaluation, Banks have to recalculate the **CVA** and **liquidity reserve**
- For **CCR**, it is assumed that the **two most vulnerable** of the largest ten **counterparties** default

- **With respect to the methodology adopted in 2020, the methodological draft for the EBA 2021 exercise does not show substantial differences for what concerns Market Risk, CCR and CVA**
- **Furthermore, there are not relevant changes in the Market Risk Full Revaluation Template (with respect to the 2020 version) that may generate impacts in current Banks' infrastructure**

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Credit Risk Main Changes

Credit Risk Methodology 2021 - the Unchanged Base

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Unchanged Base

1 **Regulatory Regime**
Banks shall consider the regulatory framework into force and applicable as of 31 Dec 2020, and the use of new internal models is mandatory as long as they're approved by competent authorities by 31 Dec 2020

2 **Perfect foresight approach**
A perfect foresight approach is adopted for the calculation of risk parameters during the time horizon of the exercise, whereby the full macroeconomic scenarios should be treated as known, provided by ECB and EBA

3 **Static Balance Sheet Assumption**
Assets / liabilities that mature or amortize within the time horizon of the exercise should be replaced with similar financial instruments in terms of type, currency, credit quality, and original maturity as at the start of the exercise.

4 **Credit Risk specific**

- The exercise must be performed under **IFRS9 accounting principles,** if the banks are subject to IFRS9, and the exposure transitions among the three impairment stages need to be projected for each year
- The static balance sheet assumption implies that **banks are not permitted to replace S3 exposures**. New S3 exposures are moved into the stock of S3, reducing the stock S1+S2 to keep constant the total exposure
- For exposures in **S2** and **S3**, banks are expected to provide **stressed lifetime expected loss rates**
- The ECL calculation for S1 and S2 is performed based on the impairment stage where the exposures are at the end of each year, **incorporating forward-looking Point-In-Time risk parameters**

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Credit Risk Methodology 2021 - Main Changes 1/2

	Main Changes	***Impact***
1	**Static Balance Sheet Assumption** ▪ For the purpose of calculating impairments and credit REA during the stress test horizon, **banks shall assume that all EBA-compliant COVID-19 moratoria are no longer in place on 1 January 2021**. ▪ For projection purposes, a loan's residual maturity and amortization schedule are those that the original loan would have had if the moratoria expired on 31 December 2020. ▪ **For the replacing loans, moratoria shall also not be considered**: once the original contract expires during the stress test horizon, the replacing loan shall feature the original contractual characteristics of the loan without considering any moratoria after 31 December 2020. ▪ **The distribution of exposures across IFRS9 stages at the beginning of 2021 must be adjusted to reflect the impact of the removal of EBA-compliant COVID-19 moratoria**	
2	**Reporting requirements** ▪ The distribution of exposure across all IFRS9 stages, adjusted to reflect the impact of the removal of EBA-compliant COVID-19 moratoria, shall be reported in the beginning-of-year baseline and beginning-of-year adverse rows of the CSV_CR_SCEN template. ▪ The stock of provisions shall be re-allocated in line with the restatement of the distribution of exposures, but provisions shall not be re-calculated in the starting point. ▪ The starting point parameters values (Transition Rates, LGD, Cure Rates and Loss Rates) shall be suitable for the projection of parameters that disregard the mitigating effect of EBA-compliant COVID-19 moratoria. ▪ **Any further COVID-19 related support measures shall be assumed to be embedded in the macroeconomic data for 2020.** If historically observed equivalents for the credit risk parameters are used as starting points, it will be considered that **observed transition rates during the moratoria period are not representative or suitable for a sufficiently conservative projection and should thus be adjusted** to disregard the mitigating effect of moratoria and capture the appropriate credit risk profile of the loans.	

Credit Risk Methodology 2021 - Main Changes 2/2

Just in Time

Main Changes

Impact

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Projected point-in-time parameters

- **The impact of moratoria shall be disregarded for the credit risk projections**. Accordingly, the accounting and regulatory flexibility foreseen for this type of exposures cannot be applied and the default can take place at any point of the stress test horizon in line with the scenario; this shall be reflected in the estimated risk parameters
- **Any further COVID-19 related support measures to be considered in the stress test shall be assumed to be embedded in the macroeconomic scenarios**. The banks' calculation of projected parameters shall be based on the restated distribution of exposures by IFRS9

Conclusions

SARS Cov 2 is the perfect example of a so-called **Black Swan**, so unexpected and devastating to lead EBA to interrupt the 2020 Stress Test to give banks the time to re-organize themselves and analyze the impact of the pandemic on their Business.

Economic shocks realized during the 2020 has been **much worse than any hypothetical adverse scenario**. And when applied to models calibrated with "ordinary" data, their impact on forecasted Risk parameters can be surprisingly huge (even tripled values with respect to their starting point), with consequent high increase of measures like Expected Losses and needed provisions for Banks.

Government Support has been meant also to mitigate this negative impact of SARS COV 2 on banks

EBA adapted Methodology after COVID-19 goes into the direction of **stressing banks' resilience further worsening the actual scenario with an unrealistic stillness of Governments in reacting against possible new negative shocks**.

Further, we have to wait the publication of Baseline and Adverse scenarios, that it is plausible to expect more stressing with respect to previous editions. Hence this mix of removal of mitigation measures, and possible worsened scenarios, may be dramatically more challenging for the banks under examination.

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Market Risk
Main Changes

Market Risk - Main Changes 1/2

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2021 methodology is characterized by three relevant changes with respect to the 2020 version, but just one can be considered really challenging for Banks

	Relevant Changes	***Impact***
1	**The impact of FX risk on positions measured at amortized cost which are in a hedging relationship (both economic hedge or hedge accounting) is excluded from the scope of the 2021 exercise** ▪ In the 2020 final version of the methodology it was true that FX risk on banking book positions not belonging to hedge accounting were excluded from the exercise. No relevant change for Banks ▪ The competent authority might request additional information regarding the hedging relationships associated to the above-mentioned positions. These information need to be reported in the explanatory note	
2	**In the context of CVA and CCR sections, the only exception for posting collateral beyond the reference date regards cash collateral of positions that are cleared at an exchange or a CCP** ▪ The previous version of the methodology didn't admit this exception, it only stated that exposures need to be reported net of stressed collateral and that no collateral that is to be called beyond the prescribed cut off date should be taken into consideration. No relevant change for banks	
3	**The 2021 methodology requires the computation of second order sensitivities (gamma and vega) for interest rates and equity positions, as of the reference date (31 December 2020). This requirement is directed to CA banks only** ▪ This change may imply a **challenge** for small Banks. The computation of second order sensitivities, such as Gamma, requires a great computational effort and financial institutions might incur in **technical difficulties** in the design of the required automated tools ▪ The final version of 2020 methodology only required the computation of first order sensitivities (delta) with respect to all risk factors included in the market risk scenario other than volatilities and the shocks for reserves for liquidity or model uncertainty	

Market Risk - Main Changes 2/2

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In addition to the previously described sharp differences with respect to the 2020 methodology, there are other three slight changes in the context of CCR and AVA that is worth mentioning.

	Slight Changes	*Impact*
1	**The 2021 methodology provides additional notes regarding PDs and LGDs computation** ▪ An internal and an external PD, both with a 3-year horizon should be considered in the CCR methodology. Banks should calculate internal PDs using their own models while external PDs should be determined based on the second-lowest long-term unsecured ratings and banks' internal mappings. ▪ The stressed LGD to be used should reflect each counterparty's default in the first year, in line with a LGD that would be used for the default of the counterparty as in the adverse scenario of the credit risk methodology.	
2	**There is a slight variation in the procedure set by the EBA for the identification of the two most vulnerable counterparties of a financial institution** ▪ Banks are required to assume the default of the two most vulnerable institutions among their ten most important counterparties ▪ The 2021 version of the algorithm prescribes an additional step: o The 10 largest counterparties shall be ranked in order of the assigned PD, from high to low. If the same PD is assigned to more than one counterparty, the counterparties with the same PD will be ranked in order of resulting losses from the default of this counterparty, from high to low.	
3	**Banks that adopt a simplified approach do not need to stress the AVA and are given the possibility to assume that it stays flat during the stress scenario** ▪ These banks should still compute the impact associated to liquidity shocks directed to the accounting reserves, moreover they should also assess the effect of model uncertainty shocks on model risk fair value adjustments.	

Company Profile

Iason is an international firm that consults Financial Institutions on Risk Management. Iason integrates deep industry knowledge with specialised expertise in Market, Liquidity, Funding, Credit and Counterparty Risk, in Organisational Set-Up and in Strategic Planning

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