

# ***Robustness, validity and significance of the ECB's asset quality review and stress test exercise***



Sascha Steffen (ESMT)

## Overview

Political environment in 2014

Challenges & Shortcomings

Stress-testing the European banking system

Implications

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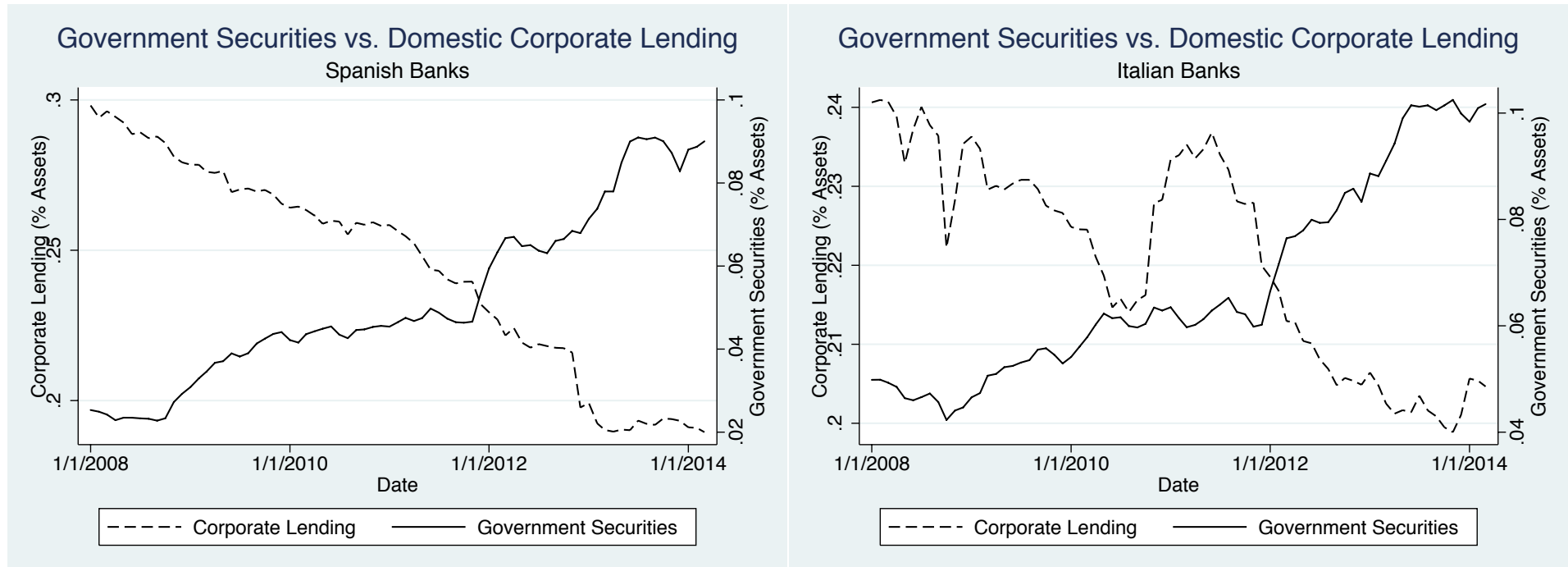
Stress-testing the European banking system

Implications

## ▶ The political situation is now different compared to 2010 & 2011, requiring a thorough cleanup of bank' balance sheets

- The political situation is different compared to 2010 and 2011.
  - European Central Bank (ECB) needs to establish reputation as regulator & maintain reputation as central bank.
- Problem banks have not been uniformly dealt with in the Eurozone by national competent authorities (NCA), and...
- ...ECB's unconventional monetary policy measures made is possible to delay dealing with troubled banks (SMP, LTRO, OMT).
- Europe and the southern periphery have been mired in recession from early 2011 onwards.

## Crowding-out of corporate lending in the Eurozone periphery



Source: Acharya and Steffen (2014), "The Greatest Carry Trade Ever? Understanding Eurozone Bank Risks", Journal of Financial Economics (forthcoming).

- The lack of capital prevents a cleaning-up of European banks' balance sheets.
  - This in turn prevents an efficient allocation of credit throughout the economy.

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- ▶ **The comprehensive assessment shows possible weaknesses both in the AQR and stress test**

### **Asset Quality Review**

- Identification and valuation of problem assets
- “Join up”

### **Stress Test**

- Design of stress tests
  - Severity and consistency of stress test scenarios
  - Horizon and static balance sheet assumption
  - Liquidity risk not modeled
  - Bottom-up approach

## ▶ The comprehensive assessment shows possible weaknesses both in the AQR and stress test (cont'd)

### Stress Test (cont'd)

- Macro-perspective is missing (systemic risk and feedback effects)
  - Contractual contagion or domino contagion
  - Information contagion
  - Fire-sale externalities
  - Price complexity contagion
  - Common Exposures
- Evaluation
  - Use of regulatory capital ratio as single benchmark
  - Recapitalization still unclear



## Implications for stress testing

- Assessing linkages between banks is important for monitoring financial stability
- Develop empirical measures of asset commonality to quantify the extent of portfolio overlap.
- Risks might still be hidden even if common exposures are identified (e.g. Thai crisis).
- Financial system comprises shadow banks, insurance companies, etc. which should be part of a stress testing exercise.
- Model possible feedback effects from the banking sector to the real sector (and vice-versa).

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## Alternative macroprudential stress tests using market data

- Benchmarks models to evaluate the outcomes of regulatory assessments.
- Different approaches
  - Rely on historical episodes
  - Use the tails of the distribution of specific risk factors
  - Stressed capital ratios
- Advantages
  - Macroprudential objective
  - Incorporate systemic risk

## Our calculations estimate that shortfalls can exceed 400 billion euros only for publicly listed banks

- Capital shortfalls of 40 public stress test banks in million euros.

Country	Equity/ Assets 4%	Equity/ Assets 7%	Market Equity/ Assets 4%	Market Equity/ Assets 7%	SRISK 5.50%
...					
Total	29,883	238,044	118,435	411,814	453,724

- Capital shortfalls estimated using regulatory capital ratios are uncorrelated with shortfalls calculated under book and/or market capital ratios.
- ECB/EBA estimates (relying on a regulatory capital ratio) might thus be very different from our estimates.

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## ▶ The objective of the comprehensive assessment might be challenged

- ECB has a keen interest to clean up the balance sheets of European largest banks.
- But substantial weaknesses with AQR and stress test remain.
- There are two aspects that may affect its incentives.
  - Who is going to pay if shortfalls are identified?
  - There are diverging interests between the ECB and national regulators
- Concerns about the validity of the comprehensive assessment has possible effects on capital and short-term funding markets.
- Objective benchmark models are a useful exercise unaffected by political interests.

**Thank you!**

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