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The EBA publishes details of its stress test scenarios and methodology

The European Banking Authority (EBA) today published documents explaining the scenarios and methodology for its 2011 EU-wide stress test, which will be applied on a wide sample of European banks covering over 60% of total EU banking assets.

The EU-wide stress test is a supervisory tool designed to assess the resilience of European banks to hypothetical external shocks. The stress test assesses what might happen to banks if external circumstances deteriorate markedly and helps to identify vulnerabilities and relevant remedial action, including strengthening capital levels where this is needed.

The documents contain information on the macro-economic scenarios and the methodologies that are used to assess the impact changes in the economic environment have on banks.

The adverse scenario, designed by the ECB, is more severe than the 2010 CEBS' exercise in terms of deviation from the baseline forecast and probability that it materialises. It includes a marked deterioration in the main macro-economic variables, such as GDP (which falls four percentage points from the baseline compared to three in the 2010 exercise), unemployment, and house prices. The adverse scenario also includes a specific sovereign stress in the EU leading to further falls in the price of some EU bonds from the already stressed levels seen at end 2010. The sovereign haircuts will apply to positions in the trading book where losses would materialise and will be accompanied by full disclosure of all relevant sovereign holdings.

The methodologies and assumptions are designed to ensure the stress is applied consistently across all the banks in the exercise. In particular, the static balance sheet assumption freezes banks' balance sheets of end 2010. This ensures consistency and prevents banks from claiming they would change their business model or sell off risky assets to mitigate the risk.

The capital threshold will be focused on a definition of core tier 1 capital which is more restrictive than the tier 1 threshold used last year. The EBA is currently defining common criteria for core tier 1 capital that will be applied consistently across the EU.

The exercise is being run between March and June 2011. During this period, a quality assurance and peer review process will be conducted by the EBA, as an independent Authority, in conjunction with the European Systemic Risk Board (ESRB). The results of the exercise will be published on a bank-by-bank basis in mid June.

The EBA is coordinating the stress test with the national supervisory authorities, the ESRB, the European Central Bank (ECB) and the European Commission.