S&P Global Ratings

Key findings from the 2023 EBA EU-wide stress tests

SUERF | Bocconi seminar

August 30th, 2023

Key Takeaways

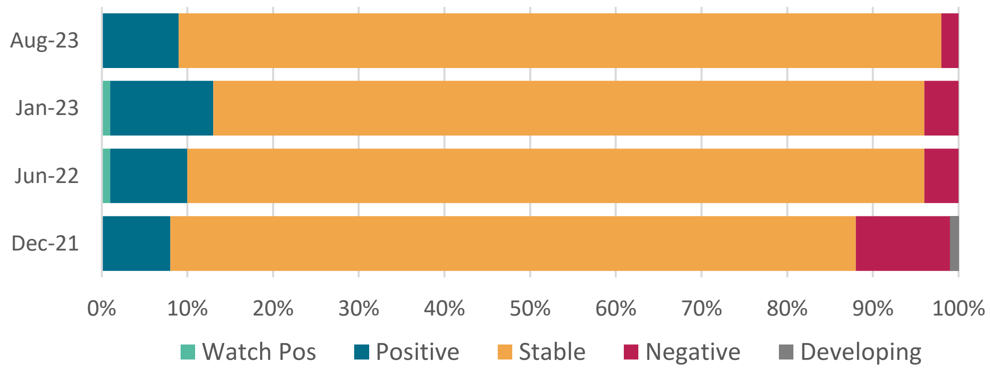
EBA stress test results confirm our view that European banks should be resilient (but divergent) as the economic reset kicks in.

- **Net outlook bias** and recent rating actions on European banks remain **tilted to the positive (slightly).**
- **Financing conditions are expected to continue to tighten**, as central banks maintain their laser focus on restoring price stability. This means rising (real) rates and a significant risk of recession later this year.
- As central banks drain off excess liquidity, **banks' funding costs will inevitably continue to rise,** and we expect large rated European banks' net interest margins and income to peak later this year.
- The rise in (real) interest rates **clouds the outlook for banks' asset quality** in 2023-24.
- That said, still comfortable **earnings and capital/liquidity buffers provide capacity to absorb** normalizing credit and funding costs.

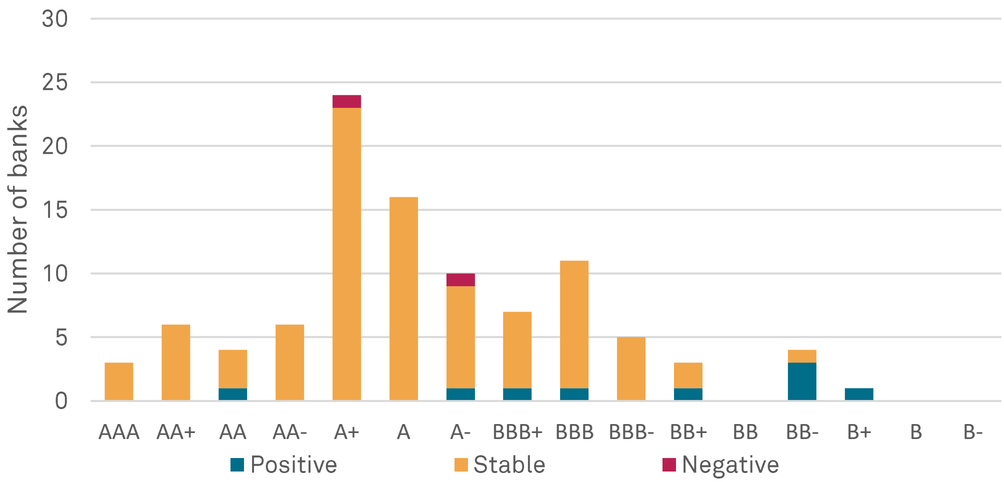
- The **EBA stress test** results inform on banks' resilience to some key downside risks and **broadly confirm our views** - we see only very few negative outliers and we do not expect that these will be subject to direct capital-strengthening measures.
- The results do not change our view of rated banks' creditworthiness, and therefore **we do not expect any direct rating implications.** Stress test disclosures provide useful insights into banks' credit risk exposures.

European Bank Ratings | Stability On The Horizon

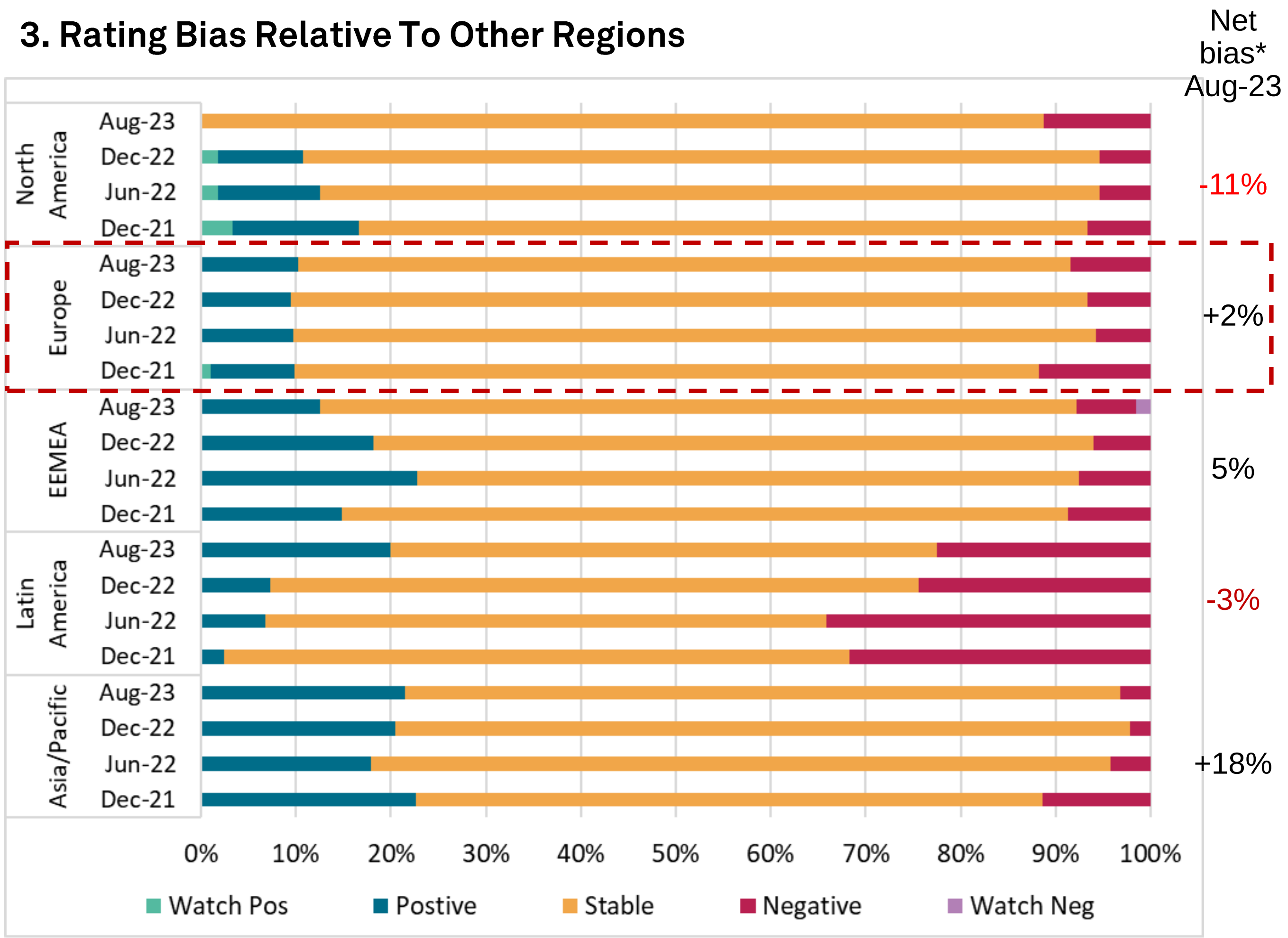
1. Slightly Positive Outlook Bias For Large Banks



2. Positive Outlooks Concentrated Among Lower Ratings



3. Rating Bias Relative To Other Regions



Charts 1 & 2: Covers Top 100 European banks only. Source: S&P Global Ratings. Data as of August 23, 2023. Data reflect outlooks at the level of the lead operating company.
Chart 3: Source: S&P Global Ratings. Data as of August 21, 2023. Reflects rating bias of all rated banks in each region. EEMEA – Eastern Europe, Middle East & Africa.
** Net bias calculated as sum of positive outlooks and CreditWatches. less sum of negative outlooks and CreditWatches.*

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Credit Conditions | Stress Test Informs On Impact Of Key Downside Risks

Downside Risks...

Aspects covered by the EBA stress test

- A protracted, **painful recession**, leading to higher corporate insolvencies and unemployment.
- Overly restrictive financial conditions due to higher (real) interest rates and potentially an acceleration of quantitative tightening, leading to **market volatility** and/or **financial instability**.
- Banks' **failure to deliver commercially and operationally** resilient business models, in a context of high inflation.

...and what they mean for the sector

- A recession could undermine the financial health of corporates and households, **weakening banks' asset quality** and business prospects.
- This scenario would pressure financial institutions with **weaker funding structures**, especially nonbank financial institutions with high refinancing needs. For banks, it would highlight the need for careful management of counterparty credit risks.
- Failure to tackle **inefficiencies**, properly **digitalize** the business, and sustain resilience to **cyber attacks** could challenge the long-term viability of some institutions.

What we expect for next 12 months

- **European banks will be resilient** but divergent as the economic reset kicks in--higher rates, slower growth.
- The rise in (real) interest rates clouds the outlook for business volumes and asset quality. **Credit costs should gradually normalize**, with those banks most exposed to commercial real estate, small and midsize enterprises, and unsecured retail loans seeing the biggest impact.
- Earnings should remain overall comfortable and allow banks to absorb future higher credit and funding costs. **Solid capitalization and liquidity** also provide resilience to potential shocks.
- As central banks drain off excess liquidity, **funding costs will continue to rise**. Net interest margins and income should peak later this year, and strong deposit franchises will be a competitive advantage.

Stress Tests | Understanding Supervisors' Methodological Choices Is Key

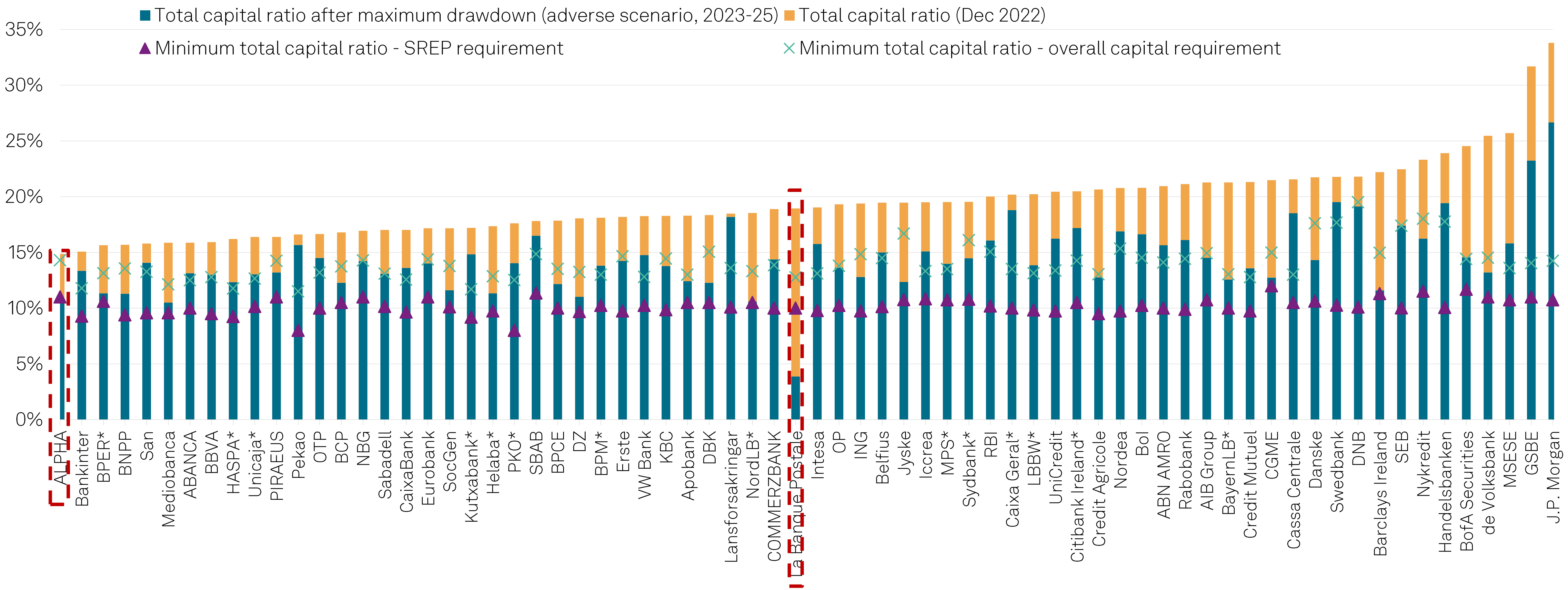
- Stress test results are **not directly comparable across juridisdictions** as supervisors made different methodological choices.
- The EBA's approach blends both the BoE's and the US Fed' approaches, seeking a balance in the realism/comparability trade-off.

	EBA	Bank of England	Federal Reserve
Balance sheet assumptions	**Static balance sheet.** No change to the asset base or business mix; fixed residual maturity of all assets; fixed dividend payout ratios--also in the adverse scenario--in line with the banks' current dividend policy.	**Dynamic balance sheet.** Banks' submissions reflect their corporate plans, with some constraints (for example no assumed decrease in lending market share in the adverse scenario, compared with the baseline)	**Static balance sheet**, including securities, trading assets, and loans. Constant risk-weighted assets (RWAs) and leverage ratio denominator, with exceptions for regulatory changes.
Credit risk modelling	**Mostly banks' models, but subject to constraints and exceptions.** For example: (i) No cure of S3 assets; no release of S3 provisions; backstop at a threefold increase in the probability of default when assessing significant increases in credit risk (SICR); credit RWAs floored at the 2022 value. (ii) Prescribed loss parameters for sovereign exposures and stressed RWAs for securitization positions.	**Banks' models.** Banks should not assume any change to their approach to calculating credit risk capital requirements, unless previously agreed with the BoE.	**Supervisory models** (depending on loan types). Based on internal credit ratings and other bank-reported data.
Profit projection	**Banks' projections, subject to constraints.** For example: (i) Net interest income (NII) cap on the increase in margin on repriced assets; overall NII cap under the adverse scenario. (ii) National financial conditions index's growth rate subject to a supervisory cap and floor in the adverse scenario. (iii) Operating expenses floored at 2022 level.	**Banks' projections with guidance.** Banks should assess the effects of the baseline and stress scenario on their liquidity positions and reflect this in their funding costs; cost reductions are expected to be "modest" and to reflect only business-as-usual considerations.	**Supervisory models.** Based on bank-provided data and stress test macro data.

Source: EBA, US Fed, Bank of England, S&P Global Ratings

EBA Stress Test | Results Confirm Broad System Resilience

Only very few banks would breach total SREP capital requirements, and about half would tap into capital buffers, under the adverse scenario



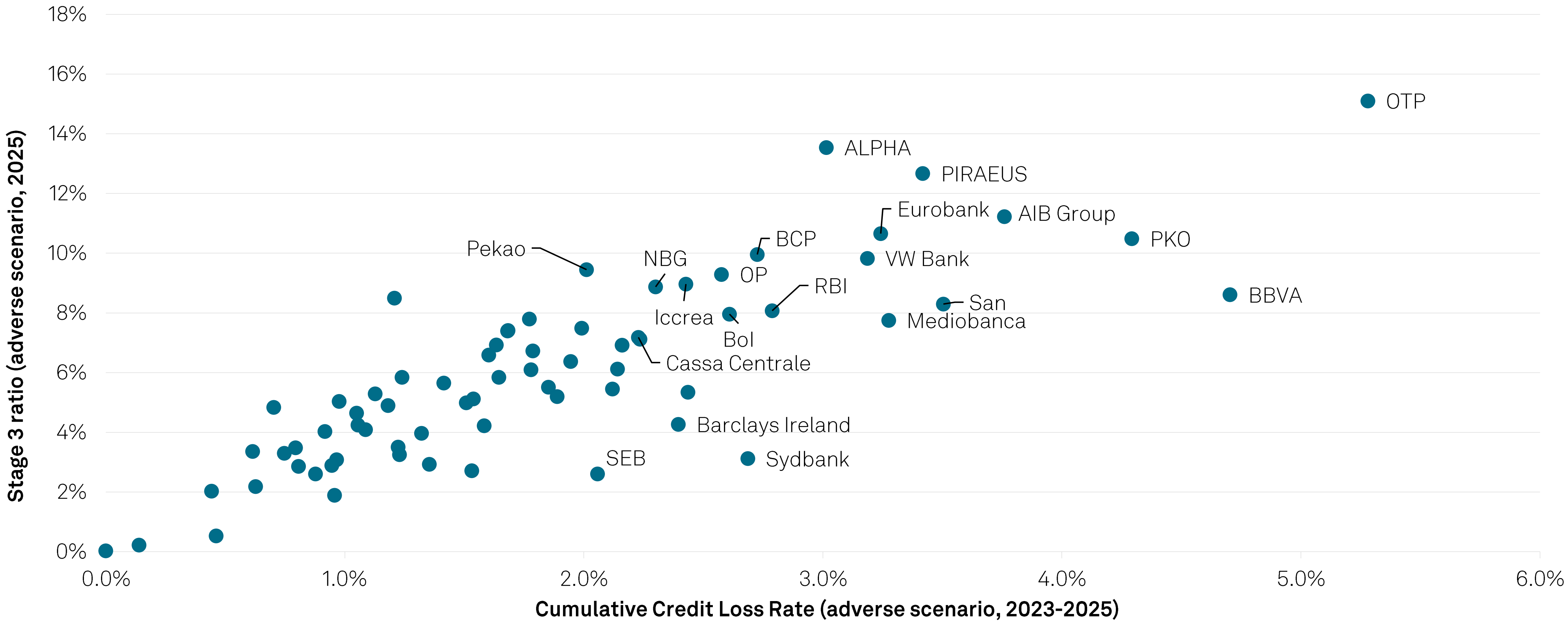
* Bank is not rated

Source: EBA; S&P Global Ratings.

EBA Stress Test | Insights Into Banks’ Credit Risk Exposures

Stress test results also provide useful information on the relative quality of banks’ credit exposures

Cumulative credit losses and Stage 3 ratio at the end of the adverse scenario (2025)



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Source: EBA; S&P Global Ratings.