



EBA EU-Wide Stress Test 2023

ABI - Supervision, Risks & Profitability

—
Milan, June 6-7 2023

The EU-wide Stress Test 2023 featured some changes vis à vis the previous exercises that posed new challenges to the participating Banks.

- Despite maintaining the characteristics of a “bottom-up” exercise, the 2023 EU-wide Stress Test included more “top-down” elements.
- What is more relevant is the huge distance of the macro environment in which the exercise unfolded and those underlying previous ones. Although the adverse scenario was quite harsh (heightened political tension, persistent inflation and high interest rate), the EBA had step in to amend the Methodology during the exercise to make it more stringent.

Sectoral Template

Banks had to report their provisions for expected losses at **sectoral level** based on sector-specific projections in the scenarios

Managerial Overlay

Banks have been asked to detail the amount of managerial overlays included in starting point Loan Loss Provisions.

Net Fees and Commissions

Banks have, for the first time, **used prescribed parameters for projecting net fee and commissions**

Leveraged Finance

ECB has carried out a **deep dive** on leveraged finance loans for **selected banks** with material exposure to leveraged finance

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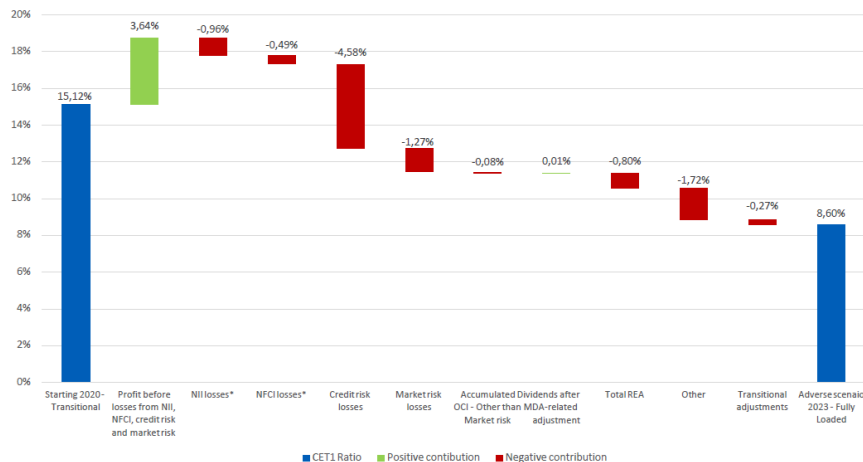
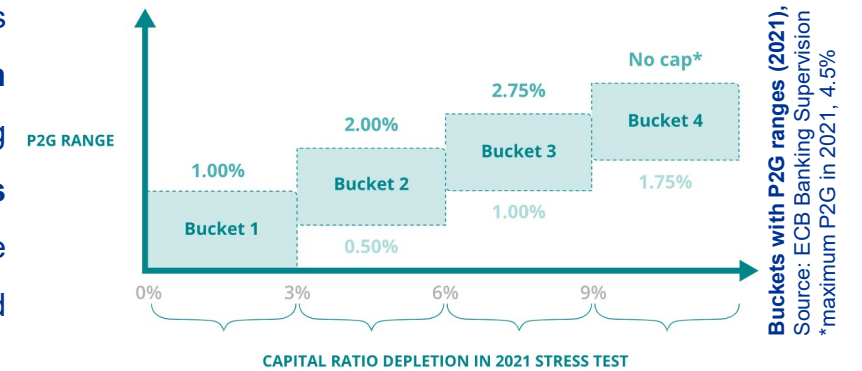
The EBA first set a top-down beta parameter for sight deposits and then amended the computation of margin component on new business, through a mid-exercise FAQ.

The Stress Test exercise has no hurdle rate to pass or fail, but it impacts the regulatory capital requirements set through the SREP assessment

The EBA ST could imply **adjustments in SREP** (and into **P2G**), so it is important to **analyse each component** that contributes to the post-stress capital ratios.



The **Pillar 2 Guidance** is determined as part of the **SREP** and establishes the **buffer of capital** that each individual bank is recommended to hold in **addition** to their binding capital requirements. The **basis** for determining bank's individual P2G levels is the **outcome of the regular EU-wide stress test**: in fact, it constitutes the first step of the “**bucketing approach**”, where each bank is allocated to a **P2G bucket** based on its maximum fully loaded CET1 capital depletion in the stress test.



The picture¹ on the left shows the **Waterfall CET1 depletion** that **Italian Banks** projected in the **Stress Test 2021**. Under the **adverse scenario** the **CET1** capital ratio of the Italian banks was projected to **fall by an average of 559 basis points** (485 bp, the EU average).



¹ Data extracted from KPMG Report “2021 EU-WIDE STRESS TEST, RESULTS” 30 July 2021



Adapting the Risk Tool-kit to the Macro Challenges

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Macroeconomic challenges call for re-assessing the Risk Tool-kit..

Three areas of investment that help Risk managers to navigate economic uncertainties

Global economy has faced multiple challenges and orthodoxies over recent decades have become more uncertain

Does this require replacing current models with brand new ones or with external scores?

No, it calls rejuvenating the toolkit banks have built over the last 15 years (roughly since when this Conference started)

Forward Looking measures

- Improve forward looking metrics to foresee risks and opportunities quickly enough to formulate sensible strategies
- Extending the predictability horizon is no simple task, but it helps in assessing relevant trends both at portfolio and obligor levels

Next slide

Improved risk Infrastructure

- Evolve the Risk infrastructure so to quickly assess the impact of multiple macro and Climate scenarios
- The infrastructure must yield outcomes in terms of RWA, ECL, prices

New data sources

- Combine multiple data sources that become available as customer habits change and IT systems improves (e.g, transactional data for SME and households)
- Use these new data in managerial models (e.g. Early Warning Systems) but also in Regulatory ones whenever possible (including ESG factors into Credit Scoring models)

....where a must-have piece is a robust Forward Looking framework.



- Developing a framework supporting reliable *what-if analysis* in terms of RWA, IFRS9 Staging allocation, ECL, becomes an important competition factor
- The framework must allow for projections differentiated between industrial sectors
- A similar setup can be then used for supporting the analysis of climate scenarios

Sector-differentiated Credit projections

1 Bottom-up & Top-down

To obtain Credit Risk Parameters conditioned on macroeconomic scenarios differentiated across industrial sectors, **the usual top-down approaches must be complemented with bottom up analysis.**

The bottom-up analysis will allow to **differentiate the macro impact to a more granular level vis à vis what allowed by satellite models.**

To this aim, the **counterparties' financial statements must be conditioned to macroeconomic scenarios** to obtain sector-specific adjustments, that will be then used together with portfolio-level projections.

2 Top-down for Climate Risk

Investing in bottom-up simulation approaches is key to forecast the impact of climate scenarios on risk parameters.

As the data necessary to link credit parameters to ESG variables are still accumulating, **the capacity to simulate counterparties financial statements under climate scenarios is what allows to derive quantitative climate risk adjustments.**

Contacts

Giovanni Pepe

Partner, Risk & Regulatory Leader

KPMG Advisory

T +39 348 3080842

giovanni pepe@kpmg.it



[kpmg.com](https://www.kpmg.com)

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