Q&A's with press release DNB 23 July 2010

What is macro stress testing and what is it used for[1]

Within the scope of regular supervision, institutions are required to perform stress tests on a regular basis, with a view to assessing their risks (micro stress testing). Supervisors compare the outcomes of these tests with other information to form an opinion on the stability of the institutions, and insofar as applicable, determine what supervisory measures would be appropriate. In addition, institutions – notably the larger ones – are frequently asked to participate in macro stress tests as part of DNB's macro prudential analysis. In these tests, institutions calculate the impact of uniform scenarios on their exposures, while DNB assesses whether the calculations sufficiently reflect the severity of the macro-economic scenarios. This process is conducted in consultation with the institutions, thus contributing to their risk awareness and DNB's insight into the risks involved. The macro stress test results provide a general picture of the financial sector's resilience. However, DNB customises the application and follow-up of the results to the individual institutions. This means that the risk profile and risk-mitigating elements, including capitalisation, are assessed per individual institution. For these assessments, the macro stress test outcomes serve as one of the sources of information.

Why are the results published on a bank-by-bank basis?

Stress tests are performed more often. The results are usually published by DNB on an aggregate level in the annual report or Overview of Financial Stability (OFS). Given the extreme developments in recent months and the volatility of financial markets, the results are published on a bank-by-bank basis this time. The objective is to provide financial markets with more information on the resilience of European banks for stress.

What are the differences with the US stress test?

This European stress test has largely a similar objective and set-up as the US stress test. However, the stress test is performed at a far later stage in the crisis and the results partly reflect that the stability of the European banking sector has already benefited from government support measures. The main difference is that the focus of the US exercise was on real estate exposures, which at that time were the largest risk. In the European stress test, a broad spectrum of risks is tested, including sovereign risks, which were not taken into account in the US stress test. In this way, the stress test considers current risks.

Is the scenario sufficiently severe?

The stress scenario requires banks to calculate the impact of a considerable number of severe shocks. Instead of an expected recovery, they have to calculate the impact of a continuing downturn.

[1] Also see DNB's Quarterly Bulletin June 2009, 'Macro stress testing as a tool for supervision and financial stability'.

Economic growth declines to 1%. Unemployment rises to 7%, compared to an unemployment ratio of less than 5% in 2009. Till now, house prices have only declined by around 6%, while in the scenario banks have to apply a 20% decline. Also commercial property prices as well as stock markets fall by 20% in the adverse scenario. These shocks are combined with a rapid rise in both short- and long-term interest rates. Hence, these shocks impact all of banks' exposures (credit and market risks). Deteriorating market conditions for sovereign risks are included in the test. As is shown by the resulting losses, these shocks form quite a severe scenario.

Will other banks also publish the results of the stress test?

The CEBS-list of 91 banks is based on an adequate representation per country, based on market share. Other bank may of course voluntarily calculate the impact of the scenario. However, CEBS has agreed that these banks will not publish the results on 23 July, but later. DNB has requested banks performing voluntary calculations not to publish the results before Monday 26 July.