

# Over-reliance on stress tests raises legality concerns

Concerns have emerged regarding EU stress tests, notably the fact that they are being used as the principal and even exclusive tool to determine a bank's financial viability

**O**n September 15 2016, the Committee on Capital Markets Regulation released a paper questioning the legality of Federal Reserve stress tests on the grounds that stress test models, which result in the imposition of binding capital requirements, are based on economic assumptions that are not disclosed or subject public comment, in breach of procedural requirements under the Administrative Procedure Act.

Stress tests designed and implemented by the European Banking Authority (EBA) and the European Central Bank (ECB) also raise legality concerns under EU law. However, these concerns are based not on the stress test process itself but rather on the excessive reliance on stress test results in the supervisory process.

## Markets and EU authorities still attribute a disproportionate weight to stress test results

Stress tests are designed to measure institutions' capital shortfalls compared to target capital ratios set by regulators in base and adverse scenarios modelled on the basis of certain macro-economic assumptions. However, such scenarios are hypothetical and stress tests are not scientific predictors of the risk of failure of the institution or of the risk the institution poses to the financial system (as evidenced by recent heightened concerns regarding Deutsche Bank, which, did not even present a capital shortfall in the 2016 stress test results published just two months prior). For this reason, a stress test shortfall, no matter how large, does not in and of itself have any legal or regulatory consequences as a matter of EU law. Instead, a stress test is only one supervisory tool among others, and the amount of capital that institutions can be required to hold must be determined not

mechanistically as the amount of a hypothetical stress test shortfall, but on the basis of an overall supervisory review and in-depth assessment of actual risks.

However, stress test shortfalls are often perceived by the market as triggering a legal requirement to raise capital for the amount of any shortfall, failing which the institution will be subject to either enforcement or placed in resolution. This over-reliance on stress tests results may trigger self-fulfilling prophecies, pushing institutions that are unable to raise the capital necessary to make up for the shortfall (which is a theoretical amount disconnected from actual risks and investor expectations) into a downward spiral, in a manner not dissimilar to the way in which investors' over-reliance on credit ratings precipitated the fall of asset prices

during the 2008 crisis.

From a legal standpoint, this over-reliance on stress test results leads to institutions – as well as shareholders and creditors who incur dilution, conversion or bail-in in connection with the corresponding capital increases – being *de facto* denied the due process and property rights protections to which they are entitled under EU law.

### One tool of the supervisory review and evaluation process

As part of their supervisory functions, EU banking authorities are required to conduct an in-depth review and evaluation of institutions under their supervision (supervisory review and evaluation process or SREP), the purpose of which is to assess the actual risks to which each institution is exposed and that it poses to the financial

system, and determine which supervisory measures are necessary and appropriate to address these risks.

Pursuant to article 97 of Directive 2013/36/EU (CRD IV), the SREP includes (A) a review of the arrangements, strategies, processes and mechanisms implemented by the institutions to comply with applicable prudential requirements and (B) an evaluation of (1) risks to which the institution is or might be exposed, (2) risks that an institution poses to the financial system and, (3) risks revealed by stress testing taking into account the nature, scale and complexity of the institution's activities.

Pursuant to article 100 of CRD IV, the purpose of supervisory stress tests is only to facilitate the SREP.

Accordingly, stress tests (which include stress tests conducted by the institutions themselves based on an internal models, as well as supervisory stress tests), are only one of several tools that banking authorities are required to use as part of the SREP. EU banking authorities are not permitted to rely exclusively on stress tests to require institutions to hold additional capital. Rather, stress tests are one of the elements that EU banking authorities must take into account when assessing the risks and deciding what supervisory measures to impose if appropriate.

The ECB inserted disclaimers in the press releases announcing the results of the July 2016 stress tests seeking to clarify the impact of the stress test results. The ECB indicated that, contrary to the 2014 comprehensive assessment, the 2016 stress tests results would not be a "pass/fail" exercise but would instead "be part of the ongoing supervisory dialog" and be used as "one input factor for the supervisory capital demand for banks". The ECB also expressly acknowledged that "[additional capital requirements] cannot be mechanically computed from the stress test results as these are one, but not the only factor taken into account."

Nevertheless, the rush by a bank such as Italy's Banca Monte dei Paschi di Siena to announce structural measures including a €5 billion (\$5.62 billion) capital increase on the eve of the scheduled announcement of the 2016 stress test results that would show a significant shortfall in an adverse scenario seems to indicate that the markets, and the EU authorities, still attribute a disproportionate weight to stress test results.

### Stress test shortfall – no legal obligation to raise capital

A stress test shortfall (whether in a baseline or adverse scenario) does not in and of itself

trigger a legally binding obligation of the institution to increase its capital up the relevant shortfall amount. In order to legally compel an institution to increase its capital – a decision which will result in either dilution or conversion and therefore significantly and adversely impact shareholders and possibly subordinated debtholders – the banking authorities are required to comply with certain substantive and procedural requirements designed to safeguard fundamental rights.

Pursuant to article 4 of Regulation 2013/1024/EU (the SSM Regulation), the ECB has the power to adopt supervisory measures in respect of credit institutions, including specific additional own funds requirements, specific publication requirements, specific liquidity requirements and other measures.

Specifically, the ECB is empowered under article 16(2) of the SSM Regulation, to require institutions *inter alia* to (i) present plans to restore compliance with supervisory requirements, (ii) apply a specific provisioning policy or treatment of assets in terms of capital requirements and/or (iii) hold capital in excess of minimum capital requirements (the so-called Pillar 2 Decision). However, the adoption of any supervisory measure, including any Pillar 2 Decision, must comply with strict requirements.

Firstly, a Pillar 2 Decision requiring an institution to hold capital in excess of minimum capital requirements at an early stage (ie at a time at which the institution is not failing or likely to fail) requires the banking authority to establish that either (1) the institution is in breach of any applicable prudential requirements, (2) there is evidence that the institution is likely to breach such requirements within the next 12 months or (3) the institution's processes does not ensure a sound management and coverage of its risks within the framework of the SREP.

Secondly, the banking authority must establish that the additional capital which the institution is required to hold under the Pillar 2 Decision relates to elements of risks and risks not already covered by Pillar 1 or buffer requirements.

Thirdly, a Pillar 2 Decision must comply with due process requirements under article 22 of the SSM Regulation and part II, title 2 of Regulation 2014/468/EU (the SSM Framework Regulation). In particular, the ECB must provide institutions the opportunity to be heard and must base its decisions only on objections on which the institutions have been able to comment. In addition, the rights of defence of the institutions must be fully respected and they must be granted access to the file.

The ECB must duly motivate its decisions by stating the legal and factual reasons thereof.

Finally, a Pillar 2 Decision must comply with general principles of EU law as reflected in European Court of Justice caselaw, pursuant to which decisions of the EU authorities, especially in matters involving broad discretion and complex economic assessment must comply with the principle

## Only a breach of a Pillar 2 requirement can trigger regulatory consequences and limit the MDA

of proportionality. Specifically, such decisions must be appropriate to achieve the legitimate purpose of the relevant legislation but must not be excessive in light of such purpose, and in particular must not excessively impact the relevant parties particularly if other, less adverse solutions, are available.

In sum, the amount by which an institution can be legally required to increase its capital pursuant to a Pillar 2 Decision must (i) be determined not solely based on stress test models determined unilaterally by regulators but only after a contradictory process fully respectful of the rights of defence and allowing the institution to have access to the file and present its observations, (ii) correspond to an amount of capital required not to address all potential and hypothetical risks but only those risks that the banking authority can demonstrate are not appropriately managed pursuant to the institution's internal process and not otherwise covered by Pillar 1 or buffer requirements and (iii) be appropriate and necessary to address the relevant risks, ie the banking authority must be able to demonstrate that no alternative measure with a less adverse impact would be capable of addressing the relevant risks. As a practical matter, the amount of the increase in capital that can legally be imposed on an institution is therefore necessarily significantly lower than the amount of any stress test shortfall.

### The concept of capital guidance

In connection with the announcement of the 2016 stress tests, the ECB and EBA introduced the concept of capital guidance, stating that the supervisory capital demand resulting from a stress test shortfall should be understood as being divided in two parts: Pillar 2 requirement and Pillar 2 guidance, and acknowledged that only the Pillar 2 requirement portion is legally binding. As a

result, only a breach of a Pillar 2 requirement can trigger regulatory consequences, and in particular limit the maximum distributable amount (MDA), which in turn restricts distributions in the form of dividends, bonuses and additional Tier 1 coupons. By contrast, a breach of Pillar 2 guidance, which is not legally binding, has no legal or regulatory consequences under EU law and in particular is not relevant for the MDA trigger.

Both the ECB and the EBA have nevertheless signalled to the market that they expect banks to comply with Pillar 2 guidance and that a breach of Pillar 2 guidance could have adverse, although unspecified consequences for banks. The ECB states that: "Nonetheless, the ECB expects banks to meet Pillar 2 guidance [...]. If a bank does not meet its Pillar 2 guidance, supervisors will carefully consider the reasons and circumstances and may define fine-tuned supervisory measures." The EBA states even more ambiguously: "Competent authorities would expect banks to meet the [Pillar 2 guidance] except when explicitly agreed, for example in severe adverse economic conditions. Competent authorities have remedial tools if an institution refuses to follow such guidance". EU authorities are therefore walking a fine line, simultaneously acknowledging that Pillar 2 guidance (which has no legal basis under EU law), is not binding, and signalling to the banks and the markets that they expect such guidance to be complied with, and where applicable disclosed to the market.

As a practical matter, the market's over-reliance on stress tests and related "capital guidance" announcements, which is not unambiguously discouraged by the regulators, results in institutions being pressed to immediately and mechanically raise capital in the amount of the relevant shortfalls, which effectively short-circuits the SREP and Pillar 2 process by relieving banking authorities from the burden to prove that the additional capital is required to cover risks not already appropriately managed or covered by Pillar 1 or buffer requirements, thereby depriving the institutions (and their stakeholders) from significant substantive and due process protections.

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