ECB's 2019 Stress Test Confirms Eurozone Banks Have Adequate Liquidity

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Key Takeaways

- The ECB's 2019 liquidity stress test results show that almost all European banks within the test's scope can withstand even an extreme hypothetical liquidity shock for at least two months.
- This outcome endorses our view that European banks have made steady progress in rebalancing their funding profiles and strengthening their liquidity positions.
- Banks are still vulnerable to foreign currency liabilities, but some retain significant capacity to generate additional liquidity if needed.
- We see the implementation of a liquidity backstop for failing systemic banks in the eurozone as a critical step toward ensuring a credible resolution framework, given global systemic and universal banks' high sensitivity to the variables used in the stress test.

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Liquidity conditions have been extremely favorable for European banks over the past few years. S&P Global Ratings therefore regards it as very timely that, this year, the European Central Bank (ECB) has conducted its supervisory analysis on how prepared supervised banks are for liquidity shocks. Expansionary monetary policy and the ECB's targeted long-term refinancing operations (LTROs) have allowed banks access to stable, cheap funding. Banks have also benefited from ample market liquidity, and investors' appetite for yield, to issue hybrids and instruments suitable for the minimum requirement for own funds and eligible liabilities, among other securities.

Moreover, the ECB's recent announcement that it will extend a third TLTRO program means that banks will continue to enjoy this convenient financing channel until 2023. The new TLTRO also gives banks, in particular small institutions in Southern Europe, more time to rebalance their funding profiles and regain market access on affordable terms.

It is no surprise to us that the ECB has concluded that European banks generally enjoy comfortable liquidity. We have the same view and consider that banks' capacity to withstand liquidity stress scenarios has improved significantly in recent years. The information disclosed by the regulator could also represent a valuable benchmark when comparing banks' liquidity and capacity to counteract shocks.

Our Liquidity Assessments Are In Line With The ECB's Results

The overwhelming majority of European banks we rate have funding and liquidity risk profiles that are generally adequate or better. Therefore, like ECB, we believe banks' liquidity buffers are generally sufficient to cover potential outflows in the stress test scenarios. The ECB's stress test indicated a few outliers, however, including four banks that would not be able to survive for more than 180 days even under the baseline scenario, which assumes a freeze of wholesale markets but no deposit withdrawals. We understand the results of the ECB's hypothetical scenarios will not have a direct impact on banks' quantitative regulatory liquidity or capital requirements.

Nevertheless, the ECB will likely push banks with indicated weaknesses to reinforce their liquidity management processes. More generally, we anticipate the regulator will keep encouraging banks to incorporate various scenario analyses into their liquidity management and internal stress testing, while enhancing their capacity to capture rating-sensitive liabilities in their data frameworks. We believe the quantitative and qualitative findings of the ECB's exercise will eventually be a relevant input in its supervisory review and evaluation process.

Consolidated Liquidity Metrics Don't Tell The Full Story

The ECB's scenario analysis reveals that, underneath their sound consolidated liquidity positions, eurozone banks tend to be more vulnerable regarding their foreign currency liabilities and the liquidity position of subsidiaries outside the EU. This highlights that most European banks manage their liquidity position on a consolidated basis. It also shows the need to look beyond consolidated liquidity coverage ratios (LCR), supporting our view that liquidity is rarely a rating strength for European banks, despite high regulatory ratios for some.

According to ECB statistics, the LCR of significant institutions in the eurozone averaged 147% as of the second quarter of 2019. We think such high consolidated ratios often reflect banks' need to hold liquidity buffers at subsidiaries, and also in various currencies. These ratios may therefore overstate banks' actual liquidity position. According to the ECB, some banks might also underestimate the implications that a potential downgrade might have on their funding base and their subsequent ability to generate sufficient liquidity.

Banks' Liquidity Buffers Are Unlikely To Change Materially

Overall, we expect eurozone banks' liquidity buffers are likely to remain broadly unchanged following the stress test. We understand the results won't have a direct impact on the banks' liquidity requirements, considering most banks were found to have sound buffers and the ECB has not set new quantitative requirements. Therefore, we do not anticipate that weaker performing banks will be required to rapidly strengthen their liquidity buffers. That said, the ECB's data should allow banks to better compare liquidity across the industry.

European banks are continuously optimizing their liquidity management in light of ongoing profitability challenges. Still, we don't expect banks will significantly relax their internal liquidity management policies because of a favorable ECB assessment, and definitely not to a point that could negatively affect our view of their funding and liquidity.

Stronger Data Consistency Will Enhance Regulatory Reporting

The consistency of banks' reported liquidity information will improve as an indirect consequence of the ECB's liquidity analysis. We see this as a positive development. The ECB's exercise identified significant improvement needs in current liquidity supervisory reports. On average, banks had to revise 25% of the data points the ECB collected, following a specific regulatory request. In addition, several banks had to restate their regulatory liquidity reports as a result of interactions with the ECB.

The number of indicators the ECB scrutinized also shows that public disclosure by banks on their liquidity would benefit from greater industrywide consistency and more detailed information, possibly including liquidity in the main currencies or at their main subsidiaries.

For Global Systemic Banks, Risks Of A Liquidity Gap In Resolution Persist

The stress test indicates that the liquidity of global systemic important banks (G-SIBs) and universal banks on average tends to be more sensitive to shocks than other banks. For the sample in the stress test, the median net liquidity position turned negative after 80 days under the extreme stress scenario. This compares with 140 days for small domestic banks and retail lenders. The difference is mainly due to the larger banks' higher reliance on less stable deposit types and wholesale funding.

The G-SIBs and universal banks' median stress test results still suggest adequate liquidity. That said, their greater sensitivity underscores the risk that in the unlikely scenario that a failing large institution needs to be recapitalized under the European bank resolution framework, it may still fail due to illiquidity. We think that the conditions that could lead to a bank resolution would likely represent an extreme stress scenario. Moreover, failing banks might consume a material part of their liquidity buffers before a resolution.

Addressing funding remains an ambiguous area of the European bank resolution framework. Neither the authorities nor the banks appear anywhere near fully prepared for such a scenario. For now, it remains unclear how this would work, but if a solution is found, it would improve the likelihood of resolutions being well executed and remove a key area of uncertainty for investors.

The Focus Of The ECB's Stress Test: Survival And The Cliff Effect

In conducting its stress test exercise, the ECB looked at how 103 European banks under its supervision would be able to survive and preserve a positive net liquidity position, which it defines as the difference between a bank's available liquidity and net outflows since the start of the stress in its short-term (six months) idiosyncratic liquidity shock scenarios. In these scenarios, banks' liabilities are expected to decrease sharply, with even stable retail deposits declining by more than 10% and much harsher assumptions for other deposits and operational liabilities.

To complete this assessment, the ECB looked mainly at two ratios:

- The survival period, which ends on the first day on which net liquidity turns negative; and
- The cliff effect, which looks at the difference between a bank's net liquidity position on day 30 and day 35 to determine if regulatory liquidity coverage ratios are overstating its real counterbalance capacity.

We consider the first as a better indicator of banks' capacity to absorb liquidity shocks.

The ECB subsequently analyzed how these indicators would evolve in two different scenarios: adverse and extreme. The results showed that, on average, banks would be able to preserve a positive net liquidity position in the adverse scenarios, whereas liquidity would turn negative in the extreme one. They also showed that the median survival period would be about 180 days in the adverse scenario and about 120 in the extreme one, an outcome that the ECB considers fairly comfortable given the harsh assumptions used in the stress scenarios. However, there is high dispersion in the sample. The ECB did not disclose results for individual banks.

Some banks' liquidity are stronger than others

More than 60% of banks the ECB examined would be able to withstand an extreme shock scenario for longer than three months. However, a few would not survive for longer than six months in the baseline scenario, which assumes the potential freezing of wholesale markets and banks' inability to roll over maturing wholesale funding. In the stress test, some liabilities are more sensitive than others to potential shocks. Hence it's reasonable to conclude that banks with higher reliance on such sources of funding are more likely to have shorter survival horizons than the others.

Also, in the extreme shock scenario, survival periods based on foreign currency liabilities (57-53 days) are generally lower than on euro-denominated liabilities (125 days). The outcome depended on entities' funding profiles and use of swaps or other liquidity management tools. The results under this scenario also point to non-eurozone subsidiaries of large banking groups having a shorter survival period (74 days) than banks in the euro area (99 days), mainly due to their higher reliance on short-term wholesale funding (including from the group) and a smaller liquidity buffer.

Banks have additional liquidity capacity

The ECB's stress test does not take into account banks' capacity to generate additional liquidity in the short term. According to data the ECB disclosed, banks analyzed would be able to generate, on average, additional collateral equivalent to 6% of total assets from unencumbered nontradable assets within six months, with an expected average haircut of 37%.

This means banks' average liquidity shortfall in the extreme scenario is less than 4%, and could be fully covered by mobilizing these assets. Moreover, according to the ECB, banks hold an additional layer of euro-denominated assets, averaging 19% of banks' balance sheets, which could be eligible for various types of secured funding transactions, if needed.

The figures indicate that eurozone banks indeed have the capacity to shore up their liquidity positions in a stress situation. Yet, according to ECB, there's significant heterogeneity in the sample of banks it analyzed. Therefore it's not feasible to draw any general conclusions.

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- ECB's Fresh Stimulus Spotlights Rising Risks For European Banks, March 8, 2019
- 2018 EU Bank Stress Test: Harsher Macro Assumptions And IFRS 9 Will Raise The Bar For Some Banks, Oct. 31, 2018

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