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UK banks
Stress test encourages further resilience

Stress test finds that core UK banking system is "significantly more resilient"

- The overall capital adequacy framework in the UK comprises three elements: annual stress tests, risk-weighted capital requirements and the Prudential Regulatory Authority's (PRA) expectation that major UK banks meet a 3% Tier 1 leverage ratio.

- The results of the first concurrent stress test of the UK banking system were released this week. The stress test was designed to assess the combined impact of the EU-wide stress scenario and the resilience of UK banks and building societies to a housing market shock, an increase in unemployment, contraction in GDP and a sharp rise in the Bank Rate.

    - Under the stress scenario, the aggregate CET1 ratio of the eight participating banks fell to a low of 7.3% in 2015, from 10.0%. Taking into account management actions (e.g. cost and dividend reductions), the aggregate CET1 ratio fell to 7.5%.

    - At end-2013, three of the eight participating banks needed to strengthen their capital positions. However, due to continuing progress in 2014 and concrete plans to build capital further, only The Co-operative Bank (unrated) was required to submit a revised capital plan.

- A qualitative review of the banks' stress testing and capital planning frameworks identified considerable differences. In particular, there was wide variation in banks' ability to provide accurate data and in the strength of modelling approaches. In addition, all banks were significantly constrained by limitations in IT infrastructure and personnel. The Bank of England has said that it will work with each participating bank to improve the quality of their stress testing going forward. Strengthening risk management practices is a key objective.

- The PRA and the Financial Policy Committee (FPC) use the results as part of their evaluation of the capital adequacy of individual institutions and the resiliency of the system as a whole. They have emphasized that this is not intended to be a pass-fail regime and results are not mechanically linked to policy responses.

Actions following the stress test

- In determining whether an individual bank needed to strengthen its capital further, the PRA considered a number of factors. The CET1 hurdle rate was 4.5% based on a definition of capital consistent with the PRA's capital regime.

    - If an individual bank's CET1 ratio remained above but close to the threshold, the PRA also considered other factors such as whether the bank's capital resources were sufficient to cover Pillar 2A requirements and the extent to which vulnerabilities in the bank's business model were tested by the particular stress scenario.

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  - Finally, the PRA assessed whether a bank in baseline projections met a 7% CET1 ratio and a 3% Tier 1 leverage ratio.

- The stress test results are one input used by the PRA to set participating banks' capital planning buffers.

- Overall, the FPC judged that the resilience of the system had improved "significantly" since the capital review exercise in 2013 and that no system-wide, macroprudential actions on bank capital were needed in response to the stress test.

- Further, the FPC decided to set the countercyclical buffer (CCB) rate for UK exposures to 0%, unchanged from September 2014. Since May 2014, UK legislation allows the FPC to reciprocate other EEA countries' CCB rates. Recognizing the potential benefits, the FPC in September decided to consider reciprocation with immediate effect (rather than from 2016 under EU law). Consequently, the 1% CCB rates set by the Norwegian and Swedish authorities will be used to calculate institution-specific CCBs for UK banks with relevant exposures in Norway and Sweden from October 2015.

- The FPC noted that a number of banks have issued "high-trigger" AT1 instruments which support resilience in a stress. In particular, some banks saw their CET1 ratios fall below 7% in the stress scenario which means that some of these instruments would have been triggered. The FPC further emphasized that investors in these instruments should be aware of this possibility in a real stress and that any coupon suspension would also support resilience.

Future stress tests

- The Bank highlighted that concurrent stress testing will continue to develop over time. Next year, the Bank will publish further details about its medium-term stress testing framework. To ensure that participating banks have sufficient time to put in place plans to improve the quality of their submissions, the 2015 exercise will not be extended beyond the eight banks included in this year's exercise.

- In future stress tests, banks are also likely to be assessed against an explicit leverage ratio threshold.

- Risks from trading activities and global credit exposures were highlighted as areas of greater focus in the 2015 stress test.

- The behaviour of risk weights in the stress scenario was identified as a potential structural vulnerability. For example, average mortgage risk weights of the seven participating banks with UK mortgage portfolios rise from around 14% at end-2013 to a peak of around 30% in the stress scenario. Risk-weight procyclicality and any inconsistencies in banks' modelling approaches will be further examined.

Specific results (for banks rated by Scope)

- As expected, due to the focus of the stress test and their business profiles, Lloyds and RBS were more impacted under the stress scenario. Next year, with the expected focus on trading activities and global credit exposures, Barclays and HSBC should be more impacted under the stress scenario.

- **Barclays**. Partly due to its geographic footprint and business model, Barclays was less impacted by the stress scenario. The projected fall in the CET1 ratio was driven by an increase in credit impairment charges, especially for retail lines, a significant increase in RWAs and exposure to conduct risks.

- **HSBC**. With its material operations outside of the UK, HSBC was less impacted by the stress scenario. Key drivers of the stress CET1 ratio were deterioration in retail, wholesale and Global Banking and Markets portfolios, resulting in increased RWAs and impairment charges, as well as exposure to conduct risks.

- **Lloyds**. While Lloyds' capital position remained above the 4.5% threshold in the stress scenario, the PRA judged that as at December 2013, Lloyds needed to further strengthen its capital position. The results showed that Lloyds remains susceptible to a severe economic downturn with potential downside risks stemming from the Group's retail and commercial lending portfolios and exposure to conduct risks. The analysis took into account the disposals mandated under the State Aid agreement, notably the sale of TSB and assumed that ordinary share dividend payments would not be made. However, in light of the positive financial results this year, the exchange of certain Tier 2 capital instruments for GBP 5.3bn of AT1 securities and continuing efforts to strengthen and de-risk the balance sheet, the PRA is not requiring Lloyds to take further actions beyond its current plans.

- **RBS**. While RBS' capital position remained above the 4.5% threshold in the stress scenario, the PRA judged that as at December 2013, RBS needed to further strengthen its capital position. The results showed that RBS remains susceptible to a severe economic downturn with potential downside risks stemming from the Group's retail and corporate lending portfolios and exposure to conduct risks. The analysis took into account the disposals mandated under the State Aid agreement, notably the sale of Citizens as well as the run down plans for RBS Capital Resolution and assumed that ordinary share dividend payments would not be made. RBS also provided assurance, independently verified by an external audit firm, regarding the treatment of deferred tax assets. Since the stress test submission, RBS has strengthened its capital position and has updated its capital plan, with plans to issue GBP 2bn in AT1 securities in 2015. The PRA stated that it would have "ordinarily required" RBS to submit a revised capital plan in light of the stress test results. However, given the progress made and the updated capital plan, the PRA decided that another action plan was not necessary.

Firm specific results

	2013 CET1	Min. stressed CET1	Min. stressed CET1 after mgt. actions	Actual CET1 3Q 2014	Min. stressed leverage ratio	Actual leverage ratio 3Q 2014
Barclays	9.1%	7.0%	7.5%	10.0%	3.0%	3.5%
HSBC	10.8%	8.7%	8.7%	11.2%	4.1%	4.6%
Lloyds	10.1%	5.0%	5.3%	12.0%	2.4%	4.7%
RBS	8.6%	4.6%	5.2%	10.8%	2.0%	3.9%

Source : Bank of England

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