EUROPEAN CENTRAL BANK
BANKING SUPERVISION

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Euro area banks have overall comfortable liquidity positions, but some vulnerabilities require further attention, ECB finds

- Banks showed adequate liquidity reserves to withstand stress
- Exercise assessed banks' ability to handle hypothetical liquidity shocks lasting six months
- Detected vulnerabilities requiring supervisory follow up relate in particular to foreign currencies, data quality and collateral management
- Findings to enter annual supervisory review

The vast majority of banks directly supervised by the European Central Bank (ECB) have overall comfortable liquidity positions despite some vulnerabilities requiring further attention, according to the results of the 2019 supervisory stress test.

The shocks simulated in the exercise were calibrated on the basis of supervisory experience gained in recent crisis episodes, without any reference to monetary policy decisions. The sensitivity analysis focussed solely on the potential impact of idiosyncratic liquidity shocks on individual banks. It did not assess the potential causes of these shocks or the impact of wider market turbulence.

The results of the exercise are broadly positive: about half of the 103 banks that took part in the exercise reported a "survival period" of more than six months under an adverse shock and more than four months under an extreme shock. The "survival period" is defined as the number of days a bank can continue to operate using available cash and collateral without access to funding markets.

The six-month time horizon exceeds the period covered by the liquidity coverage ratio, which requires banks to hold a sufficient reserve of high-quality liquid assets to allow them to survive a period of significant liquidity stress lasting 30 calendar days. Long survival periods under the severe shocks envisaged by the exercise would leave banks significant time to deploy their contingency funding plans.

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Euro area subsidiaries of significant institutions as well as banks undergoing mergers or restructuring were excluded from the sample.

Universal banks and global systemically important banks would generally be affected more severely than others by idiosyncratic liquidity shocks as they typically rely on less stable funding sources – such as wholesale and corporate deposits, which were subject to higher outflow rates in the exercise. Retail banks would be affected less strongly, given their more stable deposit base.

Based on the findings of the exercise, the ECB will require banks to follow up mainly in the following areas where vulnerabilities were identified:

- Survival periods calculated on the basis of cash flows in foreign currencies are often shorter than those reported at the consolidated level. Several banks make recourse to short term wholesale funding denominated in such currencies and some of them may be overly reliant on the continued functioning of the foreign exchange swap market.
- When considered on a stand-alone basis, subsidiaries of euro area banks domiciled outside the euro area typically display shorter survival periods than those within. While it is common for subsidiaries to rely on intragroup funding and/or funding from the parent, this may expose some banks to ring-fencing risk in foreign jurisdictions.
- Certain regulatory “optimisation strategies” revealed in the exercise will be discussed with the banks in the context of the supervisory dialogue.
- Many banks would be able to mobilise collateral in addition to readily available liquidity buffers to secure extra funding in times of need. However, collateral management practices – which are critical in the event of a liquidity crisis – would benefit from further improvement in some banks.
- Banks may underestimate the negative impact on liquidity that could result from a credit rating downgrade. Banks with recent experience of managing liquidity under stressed conditions were able to provide higher-quality data in this context.

Most banks delivered the requested information in a timely manner. At the same time, the test helped uncover data quality issues related to the liquidity reporting of a number of banks. The findings will help to improve the quality of supervisory information in the future.

Supervisors will discuss the conclusions individually with the banks as part of the annual supervisory review and evaluation process. The results will not directly affect supervisory capital requirements. They will, however, inform the assessment of banks’ governance and liquidity risk management.

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