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The 2021 EBA stress test ended on a positive note, contributing to more cheerful market sentiment alongside strong Q2 results. To nobody's surprise, the EU banking sector displays healthy capital levels (CET1 at 15%) and adequate survival levels in a severe shock scenario (CET1 capital above 10%).

Also to nobody's surprise, less diversified banks heavily dependent on net-interest revenues (which will remain under pressure due to lower-for-longer rates) would suffer more than more diversified peers. So far, so reassuring.

The EBA stress test remains an essential regulatory tool which highlights banks' prudential vulnerabilities in extreme scenarios, thus guiding supervisors' capital allocation process and offering up a unique prudential mirror to the banks. For investors and other market participants, however, supervisory stress tests exclusively targeting prudential capital levels may become less relevant. In my view, a revamping and broadening of approaches would be helpful. Why is that?

Not all troubling developments have resulted in capital depletion

In the post-GFC decade, prudential capital-focused stress tests were of course highly relevant to market participants who were trying to see which banks would be closer to a feared resolution scenario. But on balance, even with low levels of earnings, European banks have preserved and even grown their capital bases, largely by avoiding pre-GFC-type risks. A few outliers notwithstanding, resolution scenarios are more remote than ever since the new regulatory framework came into place. But being reassured that a bank can preserve adequate regulatory capital in a stressed-economy scenario may no longer be the paramount criterion for investors. Nor should it be.

Investors can grow apprehensive about specific banks even when they manage to preserve decent levels of capital, as money-laundering cases in recent years have shown. As investors and large depositors turn increasingly nervous, funding can become more expensive, new business opportunities more challenged, and the ability to issue new equity more constrained. Remember that for banks, the GFC started as a funding and liquidity crisis, not a capital crisis. It turned into that in a second stage when funding dried up and asset quality worsened.

Non-financial risks are not properly captured by supervisory stress tests

Non-financial risks for banks are growing in relative importance. A prudentially healthy bank is not necessarily a safe long-term investment unless other vectors of risk are assessed and factored in. Previous "**The Wide Angle"** reports have flagged these risks:

- Digital disruption risk
- Cyber risk
- Misconduct risk – including money laundering
- ESG risk – primarily climate-related at this time.

The bottom line with these risks is that at this time they are not being parametrised by metrics and models in a way that is widely accepted in the market. For example, even if modelling and assigning quantitative scores to climate risk is moving forward, when it relates to banks the discipline is in early stages and is insufficiently understood and adopted by investors.

Relying on external ESG scores without a proper understanding of how climate risk applies to a specific name in a specific way is sub-optimal, vaguely mirroring the blind reliance pre-GFC on credit ratings without proper investor due diligence. As for other non-financial risks, quantification is way behind or quasi-inexistent.

This should present an obvious challenge to regulators if and when they decide to attempt to stress-test non-financial risks. For example, the climate-risk exercise performed by France's ACPR earlier this year was deliberately not called a stress test, to avoid giving a false impression to the banks and to the market.

Scenario analysis can be a good proxy

Historically, to project objectivity, especially for a multi-jurisdictional exercise like the EBA stress test, supervisors have relied mostly on numbers, metrics and models. They have avoided narrative-based scenarios, as narratives can be more vulnerable than precise numbers to claims of bias from stress-tested banks or from the market. But with non-financial risks becoming more central, going down the same beaten track is almost impossible.

Avoiding any stress testing as long as proven metrics and models are not in place, or using subpar models cannot be plausible options for regulators. One compromise, at least on a temporary basis until more robust metrics and models emerge, could be scenario analysis.

Using "what ifs" with various degrees of severity could provide outcomes worth considering, even if they don't result in specific numbers like a CET1 ratio. A range of outcomes, narrowed down as much as realistically possible, would give a better image of the impact of a non-financial risk than ignoring it outright, or artificially distilling it into one metric, as equity analysts often try to do, not necessarily in a credible way.

Examples could be a bank's vulnerability to an act of cyber piracy like ransomware, or the sensitivity of a specific business line – like payments or savings – to growing competition from fintechs or big techs. A degree of transparency for the scenarios that end up being adopted and used could ensure that the outcomes are less criticised as being too biased. At the very least, scenarios should be built with sufficient inputs from the banks being stress-tested to make them accepted. After all, such scenarios would have more variables than a percentage decline in GDP or anticipation of a level of interest rates.

From an unconvincing start 10 years ago, the EBA stress tests for EU banks have become a gold standard for banks and for market participants. Broadening the scope and depth of this exercise to go beyond merely distilling it into one capital metric by including stress-testing non-financial risks, would make it even more so.

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