BRIEFING

Comprehensive assessment of selected euro area banks

The European Central Bank (ECB) is currently preparing to take on new **banking supervision tasks as part of the Single Supervisory Mechanism** (SSM), a key building block of the Banking Union.

The ECB is accountable for the exercise of its supervisory tasks towards the European Parliament (EP) and the Council. The practical aspects of how the accountability provisions are to be implemented are clarified in an **Interinstitutional Agreement** between the EP and the ECB.

Prior to assuming full responsibility for supervision on November 2014, the **SSM** performs a **comprehensive assessment** - *an asset quality review and stress tests* - in collaboration with the national competent authorities, aiming to achieve greater transparency of the banks' balance sheets and consistency of supervisory practices in Europe, ensuring the reliability of the starting point. The ECB's stress test is performed in close cooperation with the European Banking Authority (EBA).

ECB announced that it gives the banks **six to nine months** to cover capital shortfalls following the disclosure of the results of comprehensive assessment.

Recent **milestones** to establish the SSM:

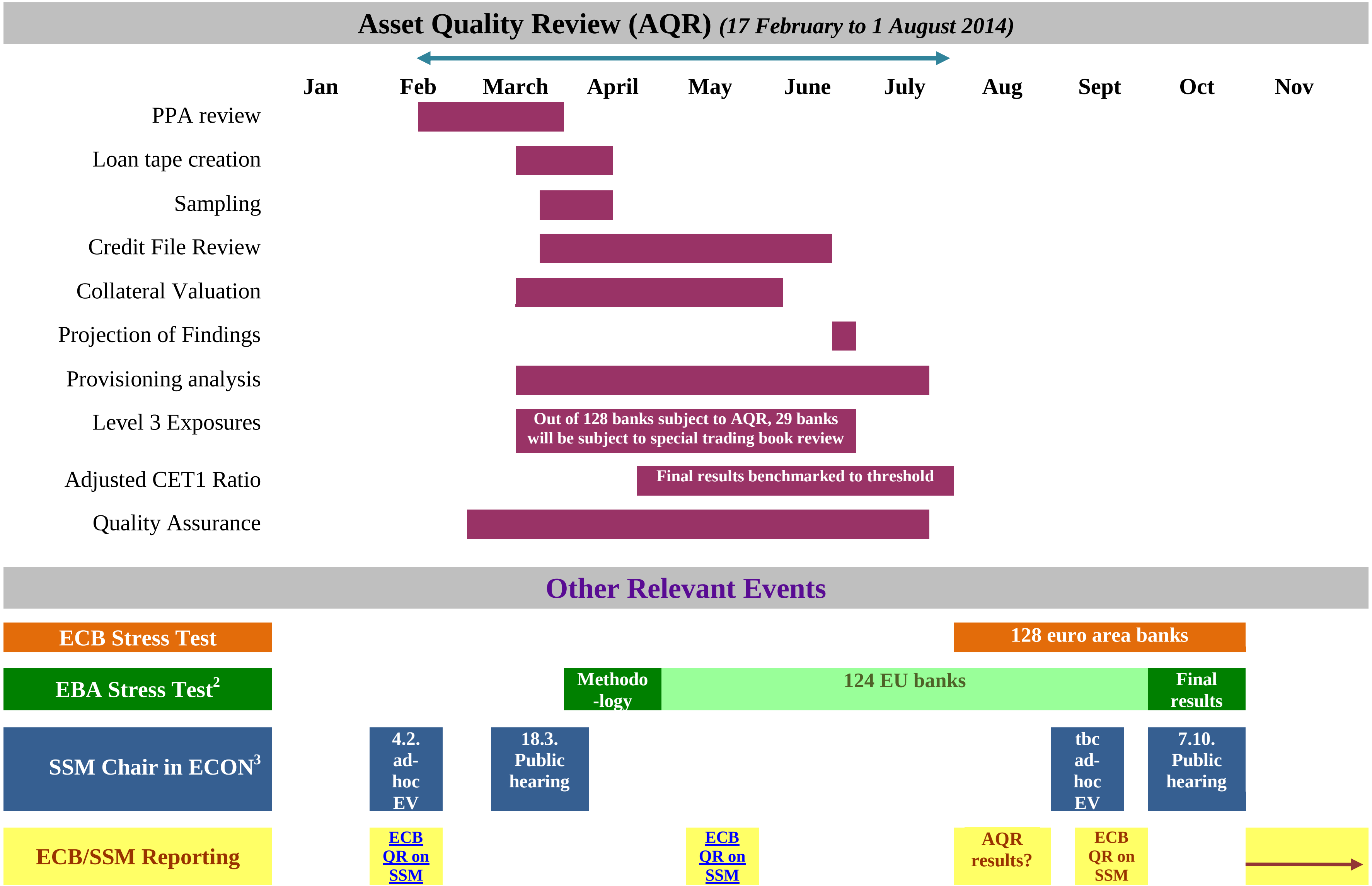
19 Mar. 2013:	EP, Council, and the European Commission (EC) reach agreement on the creation of the SSM
3 Nov. 2013:	The Regulation on the SSM comes into force, after adoption by the EP and the Council
16 Dec. 2013:	Danièle Nouy appointed as Chair of the Supervisory Board
4 Feb. 2014:	The ECB publishes the first SSM quarterly report, setting out the progress with the operational implementation of the SSM
6 Feb. 2014:	The ECB Decision comes into force which identifies those banks that are subject to the comprehensive assessment
11 Mar. 2014:	The ECB publishes its manual for the asset quality review (phase 2)
29 Apr. 2014:	The EBA publishes the common methodology and scenario for 2014 EU-banks stress test
6 May 2014:	The ECB publishes its second SSM quarterly report

This document summarizes the **timeline and key steps of the Asset Quality Review**[1] (**see Annex 1**), as well as the timeline of **rules governing the recapitalisation of banks** (**see Annex 2**) according to the provisions of the Bank Recovery and Resolution Directive and State Aid rules.

[1] Source: ECB press release, 14 March 2014 and the ECB AQR Phase 2 Manual, March 2014

 Authors: Marcel Magnus and Manica Hauptman, contact: egov@ep.europa.eu

Annex 1: Timeline and key steps of the Asset Quality Review



[2] EBA stress test is a similar but separate exercise of that of the ECB. It includes EU banks, while the ECB includes only euro area banks. 104 banks will be subject to both. For methodology see EBA website.
[3] See "Legal Base for Hearings/EV with SSM".

Annex 1: Timeline and key steps of the Asset Quality Review

STEP	OBJECTIVE	INDICATIVE TIMELINE
Processes, policies and accounting review	Bank processes, policies and accounting practices have a key impact on the carrying values of assets in banks' balance sheets and so must be reviewed. The review will cover the key topics that influence accounting balance sheet valuations. Such key topics include whether a bank correctly applies the fair value hierarchy, accounting classifications (e.g. available for sale), provisioning approach, treatment of non-performing exposures and forbearance.	**17/02/2014 - 28/03/2014**
Loan tape creation and data integrity validation	The credit analysis will be based on a "loan tape" provided by the bank. This loan tape includes account information such as segment classification, status, and credit performance data. The data must be of sufficient quality to perform the required analysis.	**17/03/2014 - 11/04/2014**
Sampling	The portfolios reviewed exceed 50% of risk weighted assets for all banks subject to the comprehensive assessment. Given the volume of analysis involved, it is not possible to review all exposures in the selected portfolio. Samples will therefore be taken, whereby specifics (such as loan classification and provisioning) of a particular credit (i.e. loans, advances, commitments or other off-balance sheet exposure) will be looked at in detail. The samples chosen must be both large and representative enough to allow for a robust analysis. The size of the sample will depend on the homogeneity of the portfolio, the risk of the portfolio, the total number of debtors and the level of debtor concentration.	**28/03/2014 - 18/04/2014**
Credit file review (CFR)	National competent authority (NCA) bank teams will verify that credit exposures have been correctly classified (e.g. placed in the correct regulatory segment, non-performing loan status, impairment status) and that, if a specific provision is required, it has been set at an appropriate level. The credit file review work block will also be used to identify cases where a loss event trigger has not been hit, but a loss is more likely than not. For these cases, the expected future loss will be measured for incorporation into the stress test. The credit file reviews will cover all loans, advances, financial leases and other off-balance sheet items, including specialised asset finance such as shipping and project finance.	**28/03/2014 - 20/06/2014**
Collateral and Real Estate valuation	A key factor in determining the appropriate carrying amounts is the valuation of collateral or on-balance sheet real estate. Generally, the majority of collateral will be re-valued for all debtors selected in the sampling that do not have a third-party valuation less than one year old. This will be carried out by NCA bank teams and will feed into other blocks of the exercise.	**14/03/2014 - 06/06/2014**
Projection of findings of (CFR)	Findings of the credit file review will then be projected to the wider portfolio, with the aim of assessing the adequacy of provisions. Projection of findings will be applied to homogeneous exposure pools.	**20/06/2014 – 27/06/2014**
Collective provision analysis	Smaller, homogeneous, impaired exposures are typically provisioned using a collective provisioning approach – that is, a point-in-time statistical model of incurred loss. Similarly, general provisions are usually set using collective models for the whole portfolio. This step aims to verify that provisioning levels are appropriate, and fully aligned with the letter and spirit of applicable accounting rules.	**14/03/2014 - 01/08/2014**
Level 3 fair value	For banks with material level 3 exposures, a thorough revaluation of the most important exposures will be	**10/03/2014 -**

Annex 1: Timeline and key steps of the Asset Quality Review

STEP	OBJECTIVE	INDICATIVE TIMELINE
exposures review	carried out on a selective basis – i.e. not all banks will be analysed. For the banks with the most important trading books, a qualitative review of trading book core processes (independent price verification, product approval, etc.) will be carried out, combined with a quantitative review of the most important derivative pricing models. It is expected that, in most cases, fewer than ten derivative pricing models will be reviewed for each bank included in the trading book review, depending on the size of the bank's exposure to level 3 derivatives. Some banks included in the trading book review will have no relevant level 3 derivative pricing models to review.	**27/06/2014**
Determination of AQR-adjusted CET1 ratio and remediation actions	Banks are only expected to change the 2013 certified accounts in the unlikely event that the AQR highlights issues that should lead to restatement according to local law, e.g. identification of accounting irregularities. Banks will be expected to reflect findings from the AQR in their accounts, where found necessary in the relevant accounting period in 2014 following the AQR. For example, banks may be expected to: - correct specific provisions for individually impaired credit facilities that were sampled in the file review; - correct specific provisions for collectively impaired credit facilities, where the bank's collective provisioning model is considered as missing crucial aspects required in accounting rules (in this case, banks would be expected to correct internal models and policies); - create a credit valuation adjustment for derivatives. Other findings from the AQR will not be included in 2014 accounts, as they do not explicitly comply with accounting rules: These include the extrapolation of findings from sampled files to the wider portfolio. Together with the stress test findings, such AQR findings will form the basis for supervisory measures requiring banks to cover potential capital shortfalls. In order to correctly account for all additional incurred losses identified within the previous work blocks, an "AQR-adjusted CET1 ratio" will be calculated for each bank. This AQR-adjusted CET1 ratio (which is calculated according to the single rule book of 1 January 2014) will be used to compute the final stress test outcomes. Banks will neither be required to restate accounts nor to apply the AQR assumptions on an on-going basis. The AQR-adjusted CET1% is not a de-facto alternative accounting standard.	**25/04/2014 - 01/08/2014**
Quality assurance and progress tracking	The NCA bank teams are responsible for all results delivered to the ECB and should apply a "four-eyes principle" to ensure the quality of the exercise at the national level. This quality assurance at the national level will not be led by the ECB, which will focus on ensuring cross-system consistency and a level playing field across systems on completion of the comprehensive assessment.	**28/02/2014 - 01/08/2014**

Annex 2: Rules governing the recapitalisation of banks

Recapitalisations: BRRD provisions and State Aid rules

A. **Precautionary recapitalisations** are meant for ***solvent institutions*** and must not be used to offset losses that an institution has incurred or is likely to incur in the near future. If a solvent institution receives public funds to address a capital shortfall based on a hypothetical **stress test scenario**, this will **not trigger resolution but result in a State Aid case**.

B. **Public recapitalisation in a resolution scenario**: If an institution, which is ***failing or likely to fail***, is unable to privately raise capital, that situation will have the following consequences for its shareholders and creditors (both State Aid rules and the provisions of the Bank Recovery and Resolution Directive (BRRD) apply): a public recapitalisation may only come after **due participation of shareholders and creditors**.