

## Euro Area

### ECB AQR: More Detail, but not on Public Backstop

- The ECB issued a press release this morning with details on its upcoming comprehensive assessment (CA) of major euro area (EA) banks, to be started in November 2013 and concluded before the Single Supervisory Mechanism comes into force in November 2014.<sup>1</sup> In the press release, the ECB highlighted that the goals of the assessment are 'transparency', 'repair' and 'confidence building' and provides broad guidance on the rationale, process, scope, methodology and timing of the assessment (see details below).
- Overall, the information contained in the announcement is close to our expectations (see [Euro Economics Weekly - Will the ECB's Comprehensive Assessment of Banks be the Euro Area's TARP Moment?](#)) and suggests that the upcoming assessment should be more transparent, consistent and stringent than previous pan-European stress tests. The scope of the assessment is perhaps somewhat broader than expected, including both on- and off-balance sheet exposures to retail, sovereign, institutional and corporate counterparties in both the banking and trading book on a worldwide basis.
- However, the release contained very little information on public backstops to fill potential capital shortfalls other than to note that 'if private sources of capital are insufficient or not readily available, public backstops might need to be drawn upon, in compliance with national practices and European rules' and referring to the outcome of the June 2013 European Council. In addition, the debate about euro area resolution arrangements and the application of bail-in rules remains far from settled. The fact that these issues have yet to be settled as well as operational challenges may explain the long time lag, but whatever the reason for the year-long delay, it is likely to be costly as the delayed repair of the financial system and lingering uncertainty about the assessment outcome will likely weigh on the prospects for the recovery to strengthen in the euro area in the coming quarters.
- Much more information also remains to be communicated at a later stage, including more precise information on the methodology of the AQR and stress test and on the practical division of labour between the ECB, national authorities and the private sector experts.

(continues overleaf)

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<sup>1</sup> See

<http://www.ecb.europa.eu/pub/pdf/other/notecomprehensiveassessment201310en.pdf?61f33d933dc5d00cf565a08bd4e21552> and European Banking Union – ECB AQR - ECB Announces Comprehensive Assessment Details

**See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.**

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## More detail, but not on Public Backstop

- **Steps:** i) a supervisory risk assessment, ii) an assessment of balance sheets as of end-2013, including an asset quality review (AQR) , iii) a stress test carried out in close cooperation with the European Banking Authority (EBA).
- **Scope:**
  - Some 130 banks covering 85% of euro area bank assets. A preliminary list of 124 banks was included, with a final list to be published in 2014.
  - The AQR will include on- and off-balance sheet exposures to retail, sovereign, institutional and corporate counterparties in both the banking and trading book on a worldwide basis.
- **Methodology:** Risk-based sampling, with reference to harmonised definitions, including the EBA guidance on non-performing exposures (and presumably forbearance). A data integrity validation to ensure the quality and consistency of the data without a full assessment of internal risk models. A conservative interpretation of International Financial Reporting Standards will be applied. Special consideration will be given to illiquid assets.
- **Capital definition:** The capital threshold will be set 8% Common Equity Tier 1 (4.5% plus 2.5% capital conservation buffer and 1% add-on for systemic relevance) according to a capital definition 'valid as of 1 January 2014' (presumably transitional Basel III). A definition that is valid 'at the end of the horizon' (perhaps 2015-6) will be used for the stress test (transitions to fully loaded Basel III take place gradually until 2019). Leverage ratios are meant to 'provide supplementary information for assessing the outcomes'.
- **Backstop:** The release notes that the CA will be followed by 'corrective measures', including potentially recapitalization ('also through profit retention, equity issuance, re-orientation of funding sources, asset separation and sales'), with timelines provided in the announcement of the results. But the release did not contain any information on the availability of public backstops other than to note that the 'ex ante availability of backstops is critical', that 'capital shortfalls identified for viable banks should, first and foremost, be made up with private sources of capital' and that 'if private sources of capital are insufficient or not readily available, public backstops might need to be drawn upon, in compliance with national practices and European rules, with the overriding goal of ensuring financial stability. As concluded by the European Council in June this year, '...Member States taking part in the SSM will make all appropriate arrangements, including the establishment of national backstops, ahead of the completion of this exercise'.
- **Division of Labour:** The release states that the ECB will 'conduct' the exercise, while the national competent authorities (NCAs) will 'execute' it at the national level. A private consulting firm will support the ECB, while all NCAs will involve private sector experts in some form.
- **Stress test:** to be conducted by ECB and EBA in close cooperation after completing the AQR, with details (methodology, scenarios, capital thresholds) to be communicated at a later date.

## Appendix A-1

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