October 2014

Reviewing and Previewing the ECB's Comprehensive Assessment from a Ratings Prospective

Key Takeaways

- As the results of the Comprehensive Assessment (CA) on 128 European banks are due to be published soon, Scope looks in some detail at the overall process, from portfolio selection at every bank to an analysis of the different outcomes of the CA (illustrated by a decision tree in this report).

- Scope is of the opinion that the CA represents an extremely useful and thorough exercise which, in particular, will enable to compare all the reviewed banks under similar criteria: reaching a level-playing field among European banks was one of the objectives of the ECB in launching the CA, and we believe that it is one of the main attractions of the exercise.

- We note that the CA is a prudential and a supervisory exercise. It does not substitute for the accounting policies and the internal processes of the different banks, and the ECB underlines this fact very clearly. Scope does not aim to substitute the published financials of the rated banks with the outcomes of the Asset Quality Review (AQR) and the Stress Test. Similarly, Scope will not directly use the assumptions of the adverse scenario in its own published earnings and balance sheet forecasts.

- Nevertheless, we intend to use the conclusions of the CA (both AQR and Stress Test) to examine in more details the asset quality of a bank's specific portfolio and the degree of accuracy of the valuation of some specific assets (collateral value of property, shipping, Level 3 assets in particular). To this extent, the CA is a very important additional tool in the analysis of European banks to the extent that it may reveal accounting misclassifications and potential underprovisioning on classes of assets that Scope initially considered properly accounted for.

- As a result, it is the thorough analysis of these "sensitive" assets that Scope will pay particular attention to, more than the simple "pass/fail" that will be triggered by the CA. For example, if a bank passes the different CA thresholds but the AQR reveals a very important negative adjustment on the CET1 ratio, Scope will investigate the findings and potentially revaluate the rating of the bank on the basis of the unaccounted for loss potential unveiled by the CA.

- Keeping in mind the thoroughness of the processes used in the CA, Scope notes three areas which are slightly less robust than the others. First, the AQR uses the "EBA simplified" approach to the definition of non performing exposure rather than the more comprehensive definition which is laid out in the implementing technical standards published in June 2014. Also, the examination of trading book assets and Level 3 derivatives is limited to a qualitative assessment of the models and processes used to evaluate these assets. Lastly, the stress test assumed a static balance sheet and gives no credit for potential management action in the course of a crisis.

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The Comprehensive assessment: a thorough and reliable analytical tool

The Comprehensive Assessment (CA) is the "financial health check" of significant banks in the euro area and participating countries. Working in conjunction with National Competent Authorities (NCAs) in participating members states, the European Central Bank (ECB) aims to complete the task before it takes over direct responsibility for supervision of significant banks of the Euro area from 4 November 2014.

The CA is made of two components: the Asset Quality Review (AQR) and the Stress Test (ST). Both components are narrowly linked and the conclusions of the former are used as the starting point of the latter.

We note that the CA is a supervisory tool. We will use it as a complement to our own analysis. It does not seek to interfer into the accounting rules of the banks under review.

We welcome the CA as a unique opportunity to cast a second look at a large variety of bank assets, consistently across the euro area. In itself, the CA will be used as an important input for some rating drivers of individual banks, particularly the ones dedicated to asset quality and market risk.

Guide to AQR

The AQR applies to 128 banks in the euro area and involves the implication of more than 6,000 supervisors and auditors from the ECB, the NCAs as well as external consultants and audit firms. In the AQR process, a total of 760 loan portfolios have been selected for detailed examination, and the review covers total banking book risk-weighted assets of approximately EUR 3.7tr representing 58% of the total credit risk-weighted assets of the in-scope banks. Corporate portfolios make up approximately 65% of selected assets, and retail assets equate to approximately 29%. 50% of the banks' significant portfolios (defined by asset segment and geography) were selected using a risk-based approach, with a focus on those portfolios most likely to carry a risk of accounting misstatement. The ECB estimates that an average of 1,250 credit files per bank has been reviewed.

Trading book assets and derivatives liabilities were analyzed for the European banks with the highest exposures. Complex fair value non-derivatives have been selected by materiality and independently revalued where chosen.

The aim of the AQR is to ensure that the financial assets of each bank are classified where they should be and provisioned as they should be. NPLs and forbearance should be considered under a common definition (which is the "EBA simplified approach") and therefore be adequately provisioned. Level 3 assets, collaterals and real estate should be properly valued.

The interest of the AQR is that it brings the potential alteration in value of all these different classes of assets down to one single number, which is the CET1 ratio. Therefore, irrespective of where the variations of value of an asset are accounted for (through equity and comprehensive income for Available-For-Sale (AFS) portfolios or through the P&L account for the portfolios held for trading), these changes would in any case impact the CET1 ratio of the given bank. The AQR would also make sure that no HTM (Held-to-Maturity) portfolio accounted at historical cost is misclassified.

Overall, the objective aim of the AQR is to obtain the **"AQR-adjusted CET1 ratio"**, defined as:
Reported transitional CET1 ratio (as of 31.12.2013) + Aggregated adjustments due to the outcome of the AQR.

A very thorough process

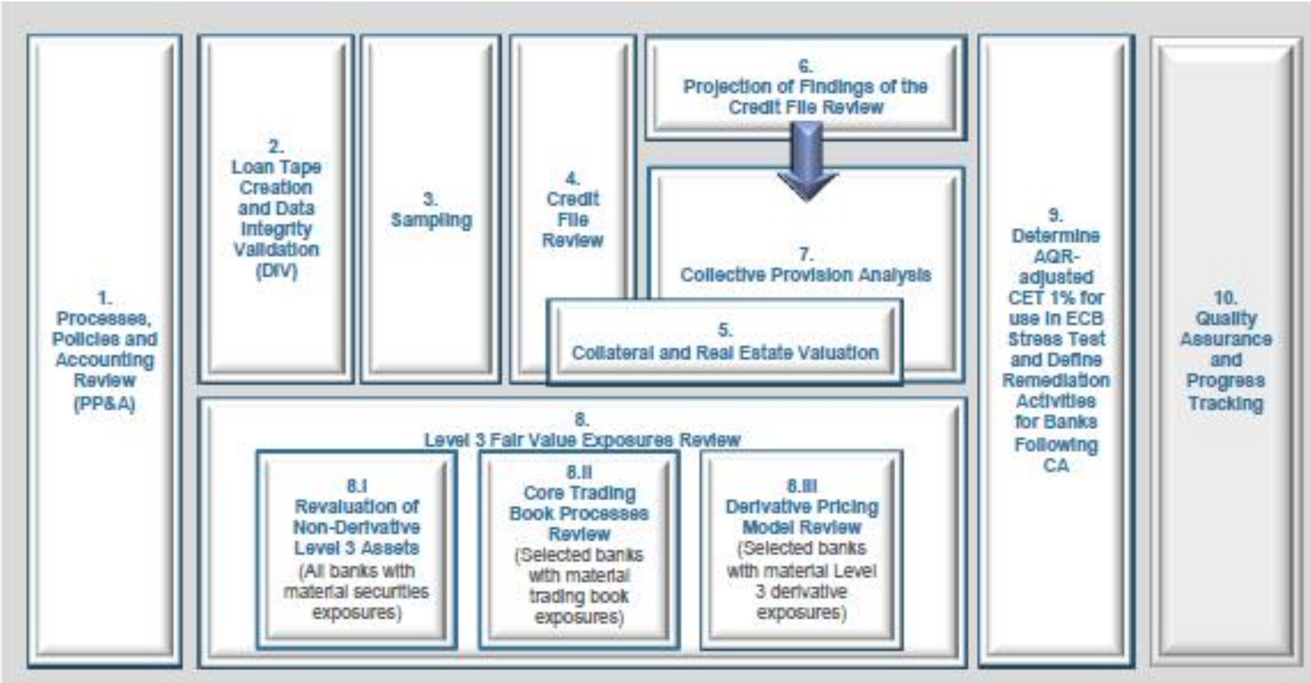
The AQR process strikes us as very thorough and very comprehensive, as demonstrated by the 10 workblocks illustrating "Phase 2" of the AQR ("Phase 1" being the portfolio selection process and "Phase 3" the collation of the results). The illustration of the Phase 2 workblocks appears on Chart 1.

Figure 1 reveals an extremely thorough review process enabling the AQR to capture a very significant amount of the banks' credit risk and a satisfactory sample of their market risk.

In the chart below, we view Workblocks 1, 4, 5, 7, 8 & 9 as critical in the assessment of the banks' asset quality while 2, 3, 6 & 10 tend to give the necessary credibility to the collection of the data, the projection of the findings of the sample to the whole bank, and to the quality assurance of the whole process.

With regards to what we could call the "asset quality workblocks", *Workblock 1 ("Processes, Policies & Accounting Reviews" – or PP&A)* is key since it focuses on the banks' interpretation of the accounting rules. In other words, a misclassified financial instrument or an inappropriate CVA calculation could lead to valuation adjustments which in turn could have an immediate impact on the CET1 ratio of the company.

Figure 1: Illustration of phase 2 Workblocks



Source: ECB, Asset Quality Review, Phase 2 Manual

Workblock 4 (Credit File Review) provides information about misclassification and under/over-provisioning of sampled exposures. The result of this workblock will end up directly impacting the AQR-adjusted CET1 ratio. This workblock consists in (1) verifying the completeness of the information provided; (2) reviewing the classification of the exposure; and (3) review individual impairment and provisioning.

Workblock 5 (Collateral and Real Estate Valuation) ensures that physical asset valuations (eg real estate, aircrafts, ships, artwork) used in the assessment of provisions or carrying values of assets are appropriate. To do so, collateral values were updated – either by having collateral revalued by a third party expert, or by updating a recent independent, external market valuation. The methodology is overall quite robust but we note that for real-estate, desk-based valuation were expected to be carried out, and not internal inspections. "Drive-by" inspections may have occurred, and in some jurisdictions some plausibility checks on the valuations (rather than a fully-fledged valuation) may have occurred as well.

Workblock 8 (Level 3 Fair Value Exposure Review) is probably the only one which is slightly less robust than the others. First, this workblock is only applicable to "significant banks". Then, even if we are confident that non-derivatives Level 3 assets will be submitted to an independent and external revaluation (similar in that to collaterals), we note that the examination of trading book assets and Level 3 derivatives will be limited to a qualitative assessment (1) of the efficacy and appropriateness of processes used to estimate fair value for all trading book positions; and (2) of the robustness of the most material pricing models used to value Level 3 derivatives (respectively). So the books themselves were not examined per se – but we note that the required processes to calculate fair value adjustments on derivatives counterparty risk are pretty comprehensive, which largely offsets that drawback.

Stress test: the main assumptions

The stress test is the second component of the comprehensive assessment. As the EBA puts it, it "serves as a common foundation on which national authorities can base their supervisory assessment of bank's resilience to relevant shocks, in order to identify residual areas of uncertainties, as well as appropriate mitigation actions. The stress test covers three years between 01 January 2014 and 31 December 2016 (as opposed to the AQR which is a picture of the bank's asset quality as of 31 December 2013).

The starting point for the stress test is the AQR-adjusted CET1 ratio (as defined in the above section). From this starting point, two scenarios are applied:

1. a baseline scenario;
2. an adverse scenario.

The *baseline scenario* is not exactly a stress test per se. The scenario is based on the winter 2014 forecasts of the European Commission extended through a model-based approach to cover 2016, which is outside the two-year horizon of the winter forecast. Interestingly, the publication of the spring forecasts has not materially amended the winter forecasts on which the baseline scenario is founded. We nonetheless note that the ECB staff projections published in August 2014 show a significantly lower GDP growth and a significantly lower inflation rate projection than the scenario of the Winter forecasts. The ECB staff projections tend to converge with the baseline scenario assumptions in 2015 and 2016.

Considering the absence of shock in this scenario (in interest rates, GDP growth or house pricing trends), we find it very unlikely that it will be the cause of significant "fails" from the tested banks. We could see a situation where a bank would fail the baseline stress test if (1) the AQR-adjusted CET1 ratio was already in a "fail" position and there was not enough retained earnings in the 2014-2016 period to offset that fail; and/or (2) the progressive phasing out of the prudential filters on AFS assets (20% of unrealised losses included in 2014, 40% in 2015 and 60% in 2016) would more than offset the benefit of retained earnings and would link to a decline in the bank's CET1 ratio. We do not believe this scenario is very likely.

The *adverse scenario* suggests a much grimmer picture for the global economy and this is really where the real stress test lies, in our opinion. To summarize the adverse scenario as designed by the ESRB:

- It factors in an increase in global bond yields amplified by an abrupt reversal in risk assessment, especially towards emerging market economies and pockets of market liquidity. The yield shock (specific by country) leads to an average increase in government bond yields of 150bps in 2014 and 115bps in 2015 and 2016.
- It also includes a further deterioration of credit quality in countries with feeble demand, with weak fundamentals and still vulnerable banking sectors.
- Stalling policy reforms jeopardizing confidence in the sustainability of public finances;
- The lack of necessary balance sheet repair to maintain affordable market funding.

All the above leads to equity price falls (between -16% and -18% for the euro area average in the three-year period) and house price falls (-7% on average in 2014, -11% in 2015 and 2016 with peaks at -15% or more in 2015 and 2016 in Belgium, Luxembourg, Denmark, Finland, Sweden, France and the UK).

The effects of the scenario are then analysed for the rest of the world outside the euro area.

Combining the effects of the shocks to the international environment (through trade, external prices and global asset prices channels) with the EU-specific shocks, the scenario leads overall to a deviation of EUR GDP from its baseline level by -2.2% in 2014, by -5.6% in 2015 and -7% in 2016. This in turn, impacts the employment rate as well as property prices world-wide.

Following the definition of the adverse scenario, the banks then have to incorporate the impact of the scenarios on the following sets of risks:

- Credit risk;
- Market risk;
- Sovereign risk;
- Securitization;
- Cost of funding.

The books of assets to be stress-tested are extremely comprehensive and cover a large proportion of accounting definition: AFS, held for trading, HtM and designated at fair value are all subject to value variations and/or complementary provisioning.

To give an example, the various shocks retained by the adverse scenario lead to significant haircuts on the banks' sovereign exposure. To name but a few, the assumed 2014 haircuts on the 10Y+ government bonds stand at 26% for Spain, close to 20% for Germany, 24% for France, 28% for Italy, 31% for Greece, 24% for the UK.

As for the AQR, the impact of the different stress tests are expressed as adjustments to CET1 ratio (in this case the AQR-adjusted CET1 ratio).

Therefore:

The **"Adjusted CET1 ratio after baseline scenario (YE 2016)"**, is defined as:
AQR-adjusted CET1 ratio (as of 31.12.2013) + Aggregate adjustments from outcome of baseline scenario stress test 2014-2016.

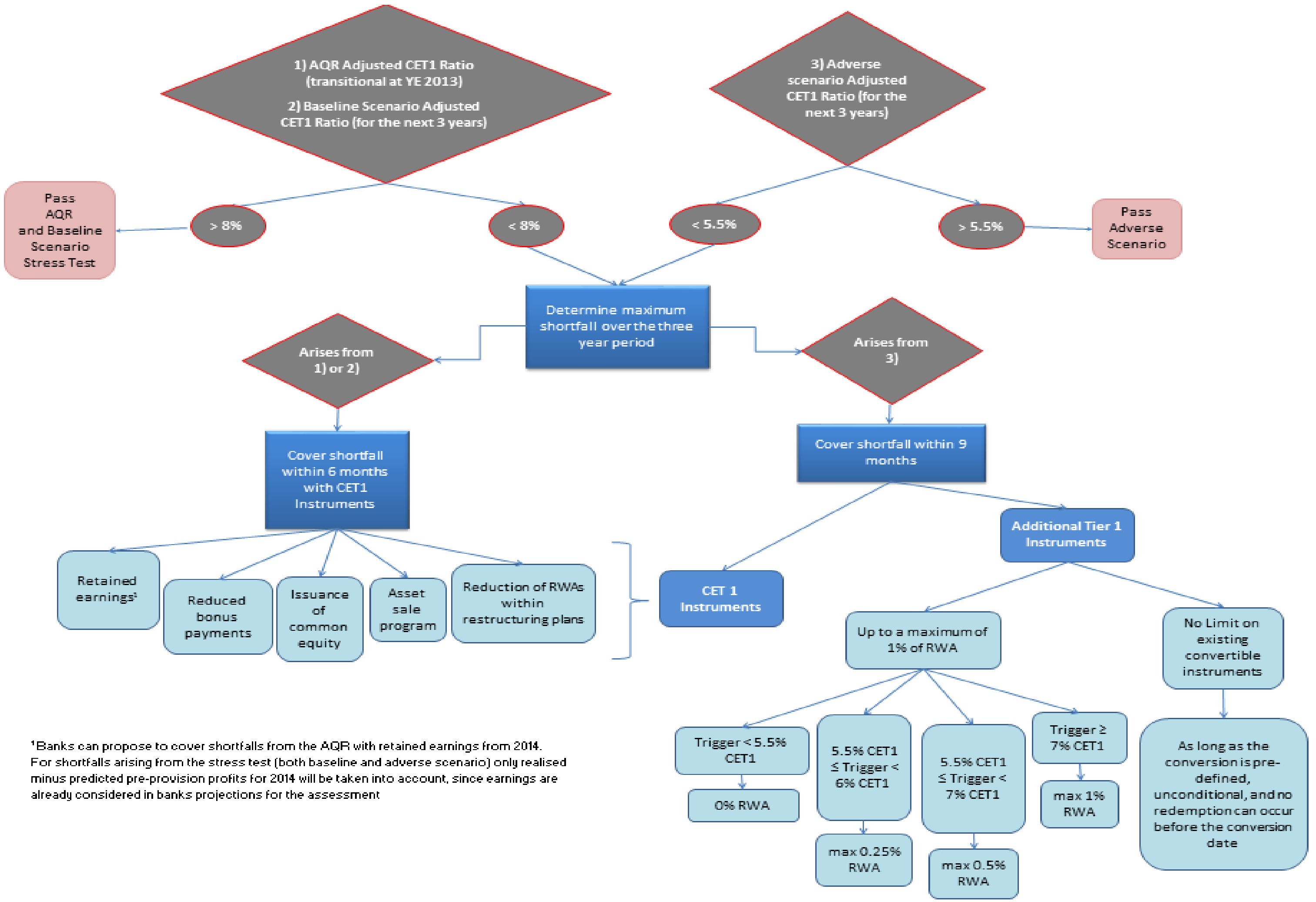
The **"Adjusted CET1 ratio after adverse scenario (YE 2016)"**, is defined as:
AQR-adjusted CET1 ratio (as of 31.12.2013) + Aggregate adjustments from outcome of adverse scenario stress test 2014-2016.

Possible outcomes for banks submitted to the comprehensive assessment

The following chart tries to illustrate the possible outcomes of the CA, both AQR and Stress Test, on a "Pass"/"Fail" basis, looking at the potential capital plans that banks can suggest to close the gap with the CA results.

A quick look at the CA results template released by the ECB last July shows that despite having to be submitted to three different thresholds (the AQR threshold, the baseline scenario threshold and the adverse scenario threshold), European banks will have to report only one capital shortfall, that will be the higher of the three potential fails (AQR, baseline or adverse) versus thresholds.

Figure 2: Decision tree on Possible outcomes of Comprehensive Assessment



Source: ECB, Scope Ratings

Answer to some criticisms

Despite being positively received by market participants, the CA has been subjected to mild criticism. We comment on the two main issues here.

- **The stress test assumes a static balance sheet and no management action.** This means that in light of what are three very long years of adverse scenario, the management of the banks is supposed to remain oblivious to change for thirty-six months in light of a meltdown environment. This is not a realistic option, in our view, but it enables to test the financials of a financial institution in a very severe environment.

- **The definition of Non Performing Exposure (NPE) retained by the AQR (aka "EBA simplified approach") is not as ambitious as the one defined by the EBA final draft implementing technical standards** (and approved by the European Commission in June 2014). In reality we feel that the NPE definitions are pretty comparable, with the only major difference being with regards to the definition of forbearance. Looking at the "Asset Quality Review Phase 2 manual", "forbearance is not explicitly included in the definition, though will be covered via prescription within IAS 39 around the impairment treatment of concessions for IFRS banks. Consideration of forbearance will not be excluded from the AQR – it will be addressed both in terms of specific credit file reviews of concessions related impairment triggers/loss events for IFRS banks and reviews of policies and processes relating to restructuring/forbearance. Findings from file reviews may lead to adjustments to NPE ratios as a consequence of forborne loans being reclassified as impaired and therefore being classified as NPE".

  Basically even if the treatment of forbearance in the AQR is far from perfect, we believe that Workblock 1 (on policies and processes) acts as a very efficient filter since it looks at what could be construed as questionable forbearance practices and policies from banks. Then there is Workblock 4 (the credit file review) which will identify foreborne loans to be reclassified as NPEs for the scope of the sampled credit file (representing on average 58% of banks' credit risk-weighted assets).

Therefore, we do not feel that the minor existing complaints on the CA are enough to put into question the usefulness and the robustness of the various analyses performed in this context.

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