EUROPEAN CENTRAL BANK

EUROSYSTEM

SSM Comprehensive Assessment
Key issues from a market perspective

Bond Market Contact Group

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Jukka Vesala

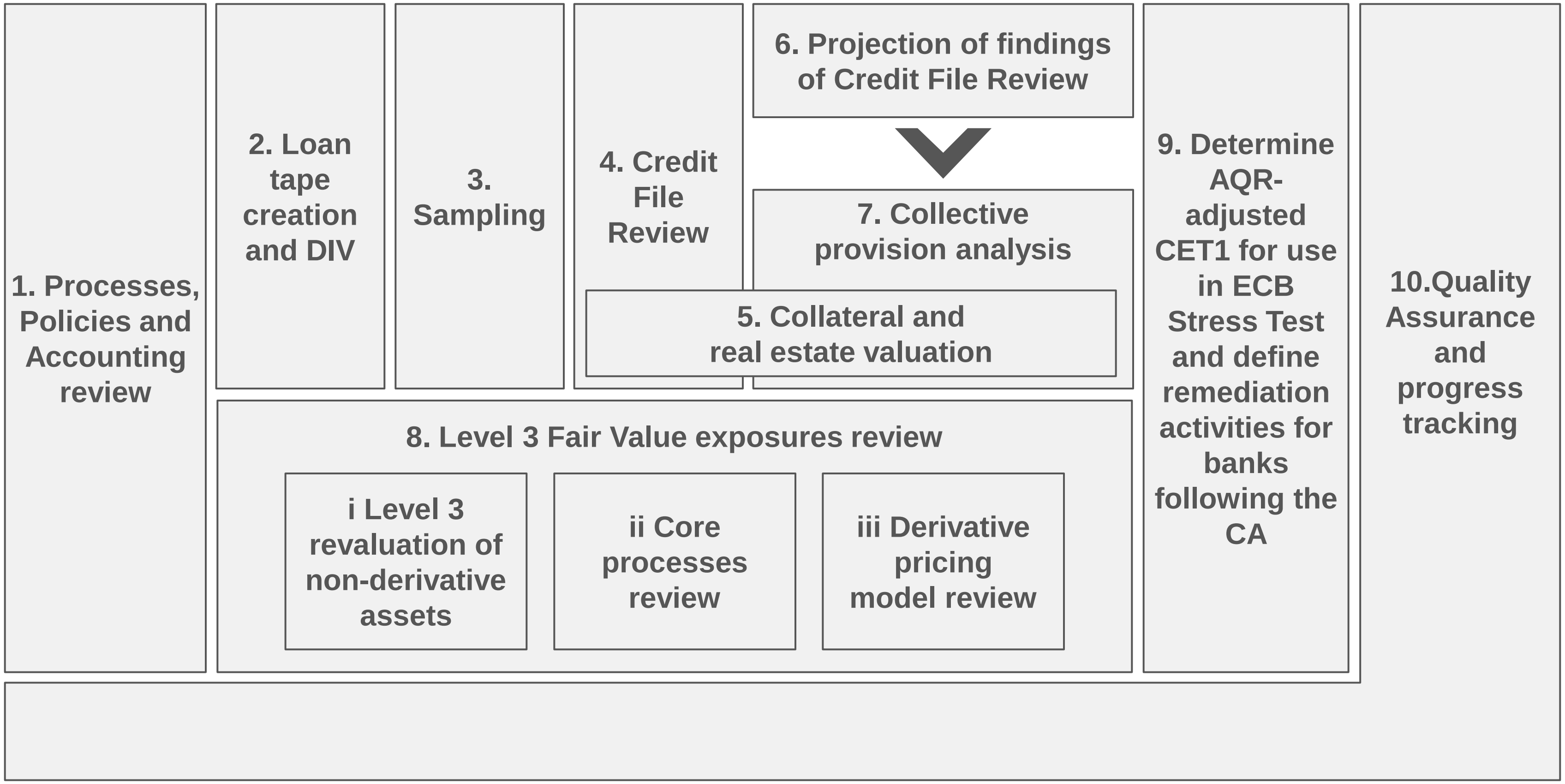
DG Micro-Prudential Supervision III

Agenda

The Comprehensive Assessment is a key priority for the ECB prior to the operational start of the SSM in November 2014

Asset Quality Review	• Assessment of data quality, asset valuations, classifications of non-performing exposures, collateral valuation and provisions • Covering credit and market exposures, following a risk-based, targeted approach
Joint ECB/ EBA Stress Test	• Forward-looking view of banks' shock-absorption capacity under stress • Conduct in collaboration with the European Banking Authority

The methodology for the AQR execution comprises 10 work blocks



As of end-June the AQR execution is at an advanced stage, with several work blocks completed and the remaining ones close to completion.

The common methodology and scenarios for the stress test published by the EBA will be applied by all banks

Key aspects of the stress test methodology and scenarios

Risks	Wide range covered, including credit and market risks, exposures in respect of securitisation as well as sovereign and funding risks
Key assumptions/ constraints	Static balance sheet assumption, prescriptions regarding the calculation of the impact on market risk and securitisation as well as caps and floors on net interest income, risk weighted assets and net trading income
Treatment of AFS prudential filters	Gradual phasing-out of all AFS prudential filters on unrealised losses during the stress test horizon (see next section)
Treatment of sovereign exposures	Phase out of prudential filters eliminates the preferential treatment allowed for sovereign debt Mark-to-market valuation losses from a specific interest rate shock

Building blocks of the stress test scenarios – four main sources of risk

Source of risk	Financial and economic shocks
Increase in global bond yields amplified by an abrupt reversal in risk assessment, including towards EMEs, and pockets of market liquidity	• Financial market shocks worldwide (sovereign bonds, corporate bonds, stock prices, etc.). • Demand shocks in EMEs • EU countries: foreign demand shocks via a decline in world trade • Currency depreciation and funding stress in CEEs
Further deterioration of credit quality in countries with feeble demand, with weak fundamentals and still vulnerable banking sectors	• EU country-specific aggregate demand shocks (via fixed capital formation and private consumption) • EU country-specific aggregate supply shocks (via shock on user cost of capital, nominal wages) • EU country-specific house price shocks
Stalling policy reforms jeopardising confidence in the sustainability of public finances	• EU country specific sovereign bond spread shocks
Lack of necessary bank balance sheet repair to maintain affordable market funding	• EU-wide shock to short-term interbank interest rates • EU country-specific shocks to borrowing costs for households and corporates (via shocks to respectively, wealth and user cost of capital)

Agenda

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2	**Key issues from a market perspective**
2.1	*Methodology*
2.2	*Disclosure of results*
2.3	*Coverage of capital shortfalls*
2.4	*General scope and depth of the assessment*

Some elements of the stress test methodology have received particular attention

- **Haircuts on sovereign bonds** resulting from a specific interest rate shock that entails mark-to-market valuation losses on sovereign exposures held for trading and designated at fair value through profit and loss(FVO), and sovereign exposures held in the available for sale (AFS) portfolio.

  - Sovereign exposures in held-to-maturity as well as loans and receivables portfolios will be treated in the same way as other credit exposures in these portfolios: impact of the scenarios on the default and loss parameters will result in larger provisions.

- **Gradual phasing-out of all AFS prudential filters on unrealised losses** during the stress test horizon → eliminates the preferential treatment allowed for sovereign debt.

  - Fraction of unrealised losses on AFS securities, including sovereign debts, that will **not** be filtered out over the stress-test horizon:

2014	2015	2016
20%	40%	60%

The disclosure of results is a crucial aspect for the market impact of the Comprehensive Assessment

- The results of the Comprehensive Assessment will be disclosed to the public simultaneously for all banks included in the exercise, at the very **end of the process in October 2013**
- Maintaining on **orderly communication process** is crucial from the perspective of all stakeholders
- The **disclosure templates** for bank-level results will be published in July, subsequent to a consultation period with banks
- Previous **feedback from market participants** has signalled strong interest in a number of aspects
  - Disclosure of asset quality indicators based on comparable definition (e.g. NPEs – simplified EBA definition applied)
  - Breakdown of results by CA component (AQR, ST baseline, ST adverse)
  - Breakdown of results by asset class
  - Information on portfolio selection

Where banks' capital ratios fall short of the relevant thresholds, remedial actions will need to be taken

Banks will be requested to submit capital plans detailing how the shortfalls will be covered

Time frame for covering shortfalls

- Depending on the source of the shortfall:
  - Six months for shortfalls identified in the AQR or the baseline stress test scenario
  - Nine months for shortfalls identified in the adverse stress test scenario
- The periods of six or nine months will start from the release of the comprehensive assessment results in October 2014

Recapitalisation measures

- Capital plans should focus on private sources of funding:
  - Retained earnings,
  - Reduced bonus payments,
  - New issuances of common equity
  - Suitably strong contingent capital,
  - Sales of selected assets at market prices
  - Reductions of RWAs associated with restructuring plans agreed with the European Commission

The use of convertible capital instruments to cover shortfalls will be subject to limits (1/2)

- Shortfalls revealed by the AQR or the baseline scenario of the stress test may only be covered with Common Equity Tier 1 (CET1) capital instruments
- Shortfalls arising from the adverse scenario of the stress test may be covered with CET1 instruments and/or convertible or write-down instruments meeting the requirements of Article 52 of the CRR (i.e. Additional Tier 1 instruments)
- The use of Additional Tier 1 instruments is limited to a maximum of 1% overall RWA, subject to the following specifications:

Level of conversion trigger	**Below 5.5% CET1**	**Above 5.5% and below 6% CET1**	**above 5.5% and below 7% CET1**	**At or above 7% CET1**
Maximum amount of shortfall that can be covered by the instrument	0% of overall RWA	up to 0.25% of overall RWA	up to 0.5% of overall RWA	up to 1% of overall RWA

The use of convertible capital instruments to cover shortfalls will be subject to limits (2/2)

Example for the use of AT1 instruments to cover a shortfall:

- *The CET1 of an institution falls to 4% of RWA under the adverse scenario of the stress test, which means a shortfall equivalent to 1.5% of RWA. The institution had previously issued AT1 instruments with different triggers (CET1 ratio of 5.75%, 6.5% and 7%).*
- *The AT1 instruments with a trigger at 5.75% may be used to cover the shortfall up to a maximum of 0.25% of RWA.*
- *The use of the AT1 instruments with a trigger at 5.75% and 6.5% is limited in total to 0.5%. If the limit for the 5.75% AT1 instruments has already been reached, the use of the AT1 instruments with a trigger at 6.5% is limited to 0.25%.*
- *The AT1 instruments with a trigger at 7% CET1 may be used to cover up to 1% of RWA. If the institution has fully utilised the limits for the AT1 instruments with lower triggers, it may cover 0.5% of RWA with these instruments.*

The Comprehensive Assessment entails a number of strong enhancements compared to past exercises

- Consistent application of uniform AQR methodology across institutions in the whole of the euro area (including uniform definitions such as NPE)

  → major increase in transparency/comparability

- Strong focus on data quality - first AQR work block (processes, policies and accounting review; data integrity validation; loan tape creation) provide a thorough basis for analyses in the later work blocks

- Point-in-time AQR results feed into the forward-looking stress test

- 2014 EBA exercise is considerably more severe than past EU-wide exercises:

  - Longer horizon of three years (compared to two-years in previous exercises)
  - Scenario parameters are more severe (e.g. with respect to cumulative difference between adverse and baseline GDP growth)

- Avoidance of pitfalls from past exercises (e.g. treatment of sovereign exposures)

- Strong focus on quality assurance for all components of the assessment (framework based on multiple layers of QA)

Issues for discussion

1. **Are there any aspects on the transparency/comparability which would need further refinement?**
2. **How do you assess the treatment of sovereign exposures?**
3. **What is in your view explaining the surge in the issuance of subordinated debt and is it related to the comprehensive assessment review?**