1 INTRODUCTION
Further progress in carrying out the comprehensive assessment of banks in the euro area has been made by the ECB, the European Banking Authority (EBA), the European Systemic Risk Board (ESRB) and the national competent authorities (NCAs) responsible for conducting banking supervision in the Single Supervisory Mechanism (SSM) Member States. An asset quality review (AQR) and an EU-wide stress test form the key elements of the assessment. Several milestones in the preparation and execution of the asset quality review have been reached over the past months. The scenarios and details of the methodological aspects of the stress test have been released by the EBA today. Throughout the rest of the comprehensive assessment, the ECB and the NCAs will increasingly interact with banks, in order to verify the data used for the assessment prior to the disclosure of results in October 2014.

2 PROGRESS IN THE ASSET QUALITY REVIEW
The AQR is the first pillar of the comprehensive assessment. The review is on track for completion within the planned time frame. Several important milestones have been reached and key processes have been initiated over the past months. On 11 March 2014 the manual containing the specific methodology for the execution phase (Phase 2) of the AQR was published on the ECB website, accompanied by summary information on the outcome of the portfolio selection process (Phase 1).

2.1 PROJECT MOBILISATION AND CROSS-BORDER COOPERATION
The mobilisation of project structures and relevant resources at the national level was finalised in time for the start of the execution phase of the AQR. NCAs have now concluded the procurement of third parties (external consultants and audit firms) that support the process. Overall, a total number of more than 6,000 supervisors and auditors...
are now working full time on the AQR. Country teams, consisting of ECB experts tasked with providing technical assistance and contributing to quality assurance at the national and central level, have been established and have started working with the NCAs. Forming a direct link between the ECB’s central project management office and the teams working on the AQR in the individual SSM Member States, the country teams play an important role in ensuring the consistent application of the AQR methodology.

The framework for cooperation between different national supervisory authorities in conducting the comprehensive assessment has been finalised, and relevant bilateral arrangements between home and host authorities have been put in place in order to clearly define their respective roles and responsibilities. This is extremely important for the execution of the AQR, as many of the institutions covered by the comprehensive assessment operate internationally and hold non-domestic portfolios which are subject to the assessment. Besides the cooperation among the NCAs of different SSM Member States, the arrangements cover the cooperation between SSM NCAs and supervisory authorities from non-SSM jurisdictions, both within and outside the European Union.

2.2 AQR EXECUTION, QUALITY ASSURANCE AND DATA CONFIDENTIALITY

Status of the AQR execution

The bank inspection teams, composed of supervisors and auditors, commenced their on-site work in February and provided results of the first work block (processes, policies and accounting (PP&A) review) by the end of March. This included a review of key topics that influence accounting balance sheet valuations, such as the application of the fair value hierarchy, accounting classifications, the approach to credit valuation adjustment (CVA), the approach to provisioning, as well as the treatment of non-performing exposures (NPEs) and forbearance. The results of the PP&A review serve to guide the analyses throughout the remaining work blocks. They are also used to identify quantitative adjustments that should be incorporated in the stress test, and to specify remediation actions that banks should undertake.

The creation of “loan tapes” by banks, including basic account information required for the selection of samples for the credit file review and the collective provisioning analysis, was concluded in April. The data integrity validation (DIV) is close to being finalised; this process involves various checks on the information obtained so as to ensure it is of
sufficient quality to perform the required analyses. The sampling of individual credit files
to be subjected to the credit file review was conducted on the basis of the loan tape data.
Sampling was necessary, as it would not be feasible to examine all exposures in a
portfolio during the credit file review. The sampling was conducted in a manner that
ensures the sample is both large enough to capture the risks of selected portfolios, and
representative enough to allow for robust analysis consistent with best practices
according to the International Standards on Auditing (ISAs).

Work on the credit file review, collateral and real estate valuation, the collective
provisioning analysis and the level 3 fair value exposures review is currently ongoing.

**Data requirements**

The ECB is aware that the requirements to collect a significant amount of granular data
within a relatively short time frame entail substantial work from banks. Consequently,
significant efforts have been made in order to streamline the relevant data templates, so as
to ensure feasibility and minimise the reporting burden without compromising the quality
of the exercise. The templates for the work blocks of Phase 2 of the AQR, as outlined in
the AQR Phase 2 manual, have been finalised and distributed to the banks and NCAs for
completion.

**Quality assurance and data confidentiality**

Quality assurance is of particular importance to safeguard the integrity and comparability
of the results of the comprehensive assessment and to maintain a level playing field
across institutions and countries. To this end, the following framework based on three
layers of quality assurance activities has been established:

a. NCA bank inspection teams, composed of supervisors and auditors, are responsible
   for validating the quality of their submissions;

b. NCAs’ technical assistance and quality assurance teams conduct further checks and
   validations across banks in the respective jurisdictions;

c. the ECB’s central project management office and the ECB country teams review
   the quality of national submissions to the centre, also carrying out cross-country
   checks and analyses.
The interplay of these different layers of quality assurance will contribute significantly to ensuring consistency in the application of the common methodology, which is a key objective of the exercise.

Ensuring the confidential treatment of all data submitted in the course of the exercise is a key priority. All parties involved in the conduct of the comprehensive assessment have signed confidentiality agreements and the ECB and NCAs have made every effort to guarantee the safe transmission and storage of data and prevent any undue access.

### 3 SCENARIOS AND METHODOLOGICAL ASPECTS OF THE EU-WIDE STRESS TEST

The common methodology and scenarios published by the EBA today will be applied by all banks participating in the 2014 EU-wide stress test, thereby ensuring that banks’ results are assessed against common assumptions, definitions and approaches. The stress test covers a wide range of risks, including credit and market risks, exposures in respect of securitisation as well as sovereign and funding risks. Moreover, the methodology incorporates a number of constraints, such as a 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 (RWAs) and net trading income.

The methodology also includes haircuts on sovereign bonds resulting from a specific interest rate shock that entails mark-to-market valuation losses on banks’ 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. It imposes a gradual phasing-out of prudential filters for the latter exposures. There will be a gradual phasing-out of all AFS prudential filters on unrealised losses during the stress test horizon. Concretely, 20% of the unrealised losses on securities, including sovereign debts in the AFS portfolio, will not be filtered out in 2014, 40% in 2015 and 60% in 2016, which eliminates the preferential treatment allowed for sovereign debt. 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: that is, the impact of the scenarios on the default and loss parameters will be calculated and will result in larger provisions.

In addition to the commonly agreed stress test methodology that is applicable to all banks in the EBA EU-wide stress test, the stress test results of SSM banks taking part in the
stress test exercise will also be influenced by the outcome of the ongoing AQR. This combination of a point-in-time AQR with the forward-looking stress test is an enhancement on past large-scale stress test exercises and, as such, is a key strength of the comprehensive assessment. As the AQR and the stress test exercises are partly conducted in parallel, ahead of the publication of the results of the comprehensive assessment, the AQR results will be integrated with the stress test results. The details of the approach for merging the AQR and stress test results will be disclosed later.

The baseline scenario was provided by the European Commission. The adverse scenario for the stress test was proposed by the ESRB in close collaboration with the ECB and the EBA, and finally approved by the EBA Board of Supervisors.

The adverse scenario captures the prevailing view of current risks facing the financial system in the EU. It provides forward-looking paths for key macroeconomic and financial variables for all EU countries and a large number of non-EU countries.

The horizon for the exercise is three years, from December 2013 to December 2016, whereas past EU-wide stress test exercises by the EBA and the Committee of European Banking Supervisors (CEBS) only covered a two-year horizon. In addition, the 2014 EBA exercise is considerably more severe than past EU-wide exercises, for example in terms of impact on GDP compared to the baseline. For instance, at the aggregate EU and euro area levels, the cumulative difference between adverse and baseline GDP growth rates is above 5 percentage points at the end of the second year of the stress test horizon compared to between 3 and 4 percentage points in the previous three EU-wide exercises. The longer horizon of three years also adds to the strictness of the exercise.

We feel confident that the effects of the approved scenarios and the integration of the AQR results in the stress test will produce meaningful and reliable results regarding banks' ability to withstand adverse conditions.

4  ELIGIBLE MEASURES TO COVER CAPITAL SHORTFALLS DETECTED IN THE COMPREHENSIVE ASSESSMENT

In cases where a bank’s capital ratio, as determined following the comprehensive assessment, falls short of the relevant thresholds, banks will be requested to take

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1 As communicated in October 2013 and February 2014, the capital adequacy threshold for the AQR and the baseline scenario of the stress test will be 8% Common Equity Tier 1 (CET1) capital, whereas a threshold of 5.5% CET1 will apply for the adverse scenario of the stress test.
remedial actions and to submit capital plans detailing how the shortfalls will be covered. Capital shortfalls will be expected to be covered within six months for those identified in the AQR or the baseline stress test scenario, and within nine months for those 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 2014².

In line with our previous communications, the banks’ capital plans should show that they will first draw on private sources of funding to strengthen their capital positions so as to meet the required targets, including retained earnings, reduced bonus payments, new issuances of common equity, suitably strong contingent capital, and sales of selected assets at market prices or reductions of RWAs associated with restructuring plans agreed with the European Commission. Reductions in risk weighted assets due to the validation and roll-out of internal models for additional portfolios, or material changes to internal models, will not be deemed eligible for addressing a capital shortfall, unless these changes had already been planned and approved by the competent authority before the disclosure of the comprehensive assessment results. The use of convertible capital instruments in this context will be subject to limits as detailed below.

Any capital shortfall revealed by the AQR and the baseline scenario of the stress test may only be covered with Common Equity Tier 1 (CET1) capital instruments as defined in Article 50 of the CRR. A capital shortfall 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 specifications³:

- instruments with a trigger below 5.5% CET1: 0% of overall RWA;

² For banks in countries under a financial assistance programme, the new coverage of capital shortfalls will be formulated within the programme provisions.

³ Example: The CET1 of an institution falls under the adverse scenario of the stress test to 4% of RWA, 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.
• instruments with a trigger at or above 5.5% CET1 and below 6% CET1: up to 0.25% overall RWA;

• instruments with a trigger at or above 5.5% CET1 and below 7% CET1: up to 0.5% overall RWA;

• instruments with a trigger at or above 7% CET1: up to 1% overall RWA.

Existing convertible instruments that are subject to unconditional pre-defined conversion into CET1 within the stress test horizon are recognised without limitation for the coverage of shortfalls, as long as (i) a certain and mandatory conversion will take place at a fixed date, (ii) these instruments cannot be redeemed before the conversion date and (iii) there is no uncertainty regarding the conversion into CET1.

State aid instruments used by Member States (Cyprus, Greece, Ireland and Portugal) in the context of financial assistance programmes are recognised without limitations for the coverage of capital shortfalls in adverse stress-test scenarios. For other SSM Member States, the grandfathering of state aid instruments provided by the CRR applies.

5 OUTLOOK ON THE PROCESS AHEAD

Upon completion of the AQR, the relevant findings from all work blocks will be incorporated in the calculation of an adjusted CET1 ratio for use in the stress test. The incorporation of AQR outcomes in the stress test constitutes a unique feature of the comprehensive assessment compared to similar previous exercises.

The results of the comprehensive assessment will be disclosed in a report at the end of the exercise in October 2014. The templates for the presentation of the outcomes at the level of individual banks will be published ahead of the final disclosure of results, ensuring that all relevant stakeholders are provided with advance certainty regarding the scope and format of their final content. Banks will be consulted on these templates before publication.

Prior to the release of results, the ECB and the NCAs will interact with banks at different stages, in line with normal supervisory practice. These interactions will serve to validate the information used for the assessment and may include discussions on partial aspects of AQR work blocks, such as the data integrity validation and the credit file review. Their aim is to ensure that the drivers of the final results have been subject to the standard procedures of discussion and challenge that form part of normal supervisory practice.