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Comprehensive Assessment: How to Prepare for the Results and What to Do Next

Ladies and gentlemen,
First of all, many thanks to Andreas and Danièle. Ms. Nouy, you have painted an impressive picture for us of what you expect from the Single Supervisory Mechanism (SSM) and have outlined some of the challenges awaiting us. I would like to follow up on this and say a few words on the Comprehensive Assessment, which is supposed to – and certainly will – get European supervision off to a smooth start but which is itself not yet without points of friction.

128 banks that have been categorised as "important" and are expected to come under the direct supervision of the European Central Bank are taking part is this assessment. As you will no doubt know, they must among other things undergo an Asset Quality Review (AQR) and a stress test. I am not exaggerating when I say that the Comprehensive Assessment is an examination of historic proportions for *all* those involved. They now *have* to pass it – with no dress rehearsal.

What is especially important for us is that the results of the Comprehensive Assessment must be reliable, credible and of a high quality. This objective currently has priority. But at the same time we must prepare ourselves for the time that comes after and ask ourselves how we will handle the results, which are awaited with much excitement. I'll come back to that later.

Phase 1 of the current Asset Quality Review, the portfolio selection, has already been completed. We are now in the middle of Phase 2, the impairment tests, which are being carried out in Germany, as in other countries, by certified public accountants in cooperation with Deutsche Bundesbank und the Federal Financial Supervisory Authority (BaFin).

In order to shoulder the weight of the huge Asset Quality Review project, BaFin and the Deutsche Bundesbank have created an extensive infrastructure, as the ECB has also called for. Among other things, there are now the National Steering Committee (NSC), the Project Management Office (PMO) and the Quality Assurance & Technical Assistance Team (QA&TAT). We have also established a helpdesk function to manage the tide of queries from the banks and accountants. Weekly internal reporting is intended to ensure that

any risks to the project are identified early and addressed effectively. The Quality Assurance Concept aids – as its name states – quality assurance of the AQR. In addition, ECB country teams are to support national supervisors. In practice, however, the work of these teams is limited to overseeing work at the national level, thus controlling the NCAs. Germany is bringing 24 banks to the party and – unlike any other SSM-country – has its own country team. For that reason our impression may not be representative.

No matter how elaborate the infrastructure, in the case of the Asset Quality Review many obstacles still have to be overcome. The whole thing is like a hurdles race for which a highly ambi-

tious time target has been set. We are all feeling the heat of the fixed deadline of 4 November. For that reason, many jobs are running in parallel that would in other circumstances tend to follow one another. Hold-ups in this complex structure, be they only data being delivered late for technical reasons or a question directed to the ECB helpdesk not being answered without delay, may throw the whole process out of kilter. But that is not an option – it promptly has to end. Therefore, pragmatism and good supervisory judgement are key.

The immense time pressure is a fundamental problem of the Comprehensive Assessment. What we have here is a case of credibility versus feasibility and definitively a high operating risk. On the one hand, the data must be of a high quality, in order to guarantee the credibility of the Review. On the other hand, because of the sheer volume of data required, in the short time available the data quality requirements are often too much to manage for both the banks and the supervisors and accountants involved. Some banks are complaining that their day-to-day business is suffering considerably and that the workload is completely overwhelming them. What is often at issue is how the templates in which the banks have to insert non-standardised data, or data that they do not hold for their own management or do not hold in this form, are designed. And this remains an issue despite the testing of these templates with banks and NCAs.

I therefore have some sympathy for the European Banking Federation (EBF), which is urging the ECB to reduce the data queries. In some cases BaFin and the Deutsche Bundesbank have also questioned the sense of data requests and have managed to persuade the ECB to simplify templates. This subject is bound to keep us busy during the months ahead as well. But I am sure that the ECB management will approach the matter in a careful and considered manner.

Something else that is susceptible to disruption is cooperation between home country and host country supervisory authorities. The need to consult and agree is great. Responsibilities must therefore be clearly defined and demarcated in order to prevent friction and time losses.

One particular problem is that some states outside the SSM expressed general reservations about the Asset Quality Reviews. For instance, in some countries outside the euro area there are legal restrictions that prevent the unencrypted transfer of borrower data to third parties. A solution had to be found, especially since in Germany certified public accountants are collaborating in the reviews as third parties. It took us a lot of hard negotiating and a lot of persuasion before a workaround was finally agreed with these countries. Naturally, such negotiations also tie up resources and may give rise to delays in the process. But national supervisors and the colleges have no legal leverage in the ECB to force, say, the Brazilian supervisory authority to transfer data.

There is *another* point which in our view has not been finally settled yet: the relationship of prevailing accounting standards and certain Asset Quality Review findings. This in the end will be a question of enforceability of any capital requirements resulting from the Comprehensive Assessment.

If the Asset Quality Review reveals deviations from the relevant accounting standards, then the banks must adjust their 2014 accounts accordingly. This has nothing to do, though, with the so called "adjusted CET 1 ratio", a mathematical variable which according to the ECB's ideas is meant to create a standardised and conservative basis for the stress test and to make the results comparable. For the time being, this adjusted CET 1 ratio is not to be taken into consideration in the banks' annual financial statements. In the calculation of the adjusted CET 1 ratio, there will be temporary restrictions on valuation options that exist under the current IFRS or national GAAP. The ECB describes this procedure as "lines in the sand", which hopefully does not mean "built on sand". The restrictions therefore apply solely to the Comprehensive Assessment and have no lasting influence on official accounting.

The ECB will, for example, use a so-called "challenger model" to calculate general loan loss provisions. If the value calculated by the ECB is more than 10% higher than that arrived at by the banks using their internal models, the causes will be sought. So far, so good. If there is no plausible explanation for the difference, the challenger model will be used in the Asset Quality Review in order to adjust the estimated loan losses. That also sounds quite reasonable and appropriate. However, a sense of proportion is called for here, since the challenger model uses only two dates (end-2012 and end-2013) for the calibration of the calculation parameters and is therefore inevitably less precise than internal bank models. In addition, adjustments to estimated loan losses based on the challenger model are also scheduled to be taken into account in the stress test. So they have a substantial knock-on effect.

There is therefore a danger of the Asset Quality Review departing from the accounting rules, even though it continues to use them as a basis. Although creating better comparability is the right way, if a capital shortfall were to arise in the stress test, the ECB's demand for additional capital to make good the shortfall would be based on these conservative and partly modelled values. So not only would the scope for discretion be de facto restricted at the accounting level, but also bank-specific valuation approaches would be replaced by model assumptions. The adjusted CET 1 ratio would have an impact on the banks' balance sheets by the back door. The banks might think of attacking the idea of setting aside more capital in this way. It remains to be seen whether the ECB draws its "lines in the sand" or whether a new "de facto standard" for regulatory accounting is created that is someday carved in stone. What I would like is clear consistent and conservative rules with a sense of proportion. The existing accounting framework including national implementation has to be respected and the entire endeavour has to be put on a firm legal footing.

Just a few more words on the stress test, ladies and gentlemen. As you know, on 29 April the European Banking Authority (EBA) published the methodology and macroeconomic scenarios for the 2014 bank stress test. With a common methodology, standardised scenarios and coordinated disclosure the EBA wants to ensure consistent and comparable results. As before: So far, so good. But I still see some points open to criticism with regard to the stress test as well. And: A few aspects of the methodology raise questions.

Such as the area of funding. In its Methodology Note the EBA does not aim to replace central bank refinancing universally by market funding. Rather, it calls for the ECB's longer-term refinancing operations (LTROs) to be replaced as they expire by the ECB's main refinancing operations (MROs). As you are aware, longer-term refinancing operations were intended to provide the banks with the liquidity they needed at the height of the crisis for security of planning purposes. These were, it was said, exceptional and temporary measures. I am not in favour of longer-term refinancing operations being replaced by other forms of central bank refinancing, since that would delay the return of the interbank market to precrisis mode. I would therefore be in favour of replacing any form of central bank refinancing by market funding in the baseline scenario. The ECB Council, on the other hand, envisages unlimited main refinancing operations up to 2015. On the basis of the stress test methodology, this also means some imbalance between those banks that are market-funded today and those that are still availing themselves of LTROs. The ECB will – that would be at least my expectation – have to address this in its evaluation of the results.

Another question that I am not the only one to be preoccupied by is: How can the results of the Asset Quality Review be used in the stress test? The bank balance sheets that are being examined in the Asset Quality Review are, as we know, going to be used as the basis for the stress test. However, for time reasons, both exercises are in part running alongside each other. How we might link the two is still the subject of intense discussion. At the centre lie two different approaches:

The *top-down join-up approach,* in which the banks first perform the stress test calculations on the basis of their annual financial statements as of 31 December 2013. The results of the Asset Quality Review are ignored. The ECB then adjusts the stress test results on the basis of standardised assumptions about the results of the Asset Quality Review. With this approach, the banks themselves are not directly involved nor can they re-run the results.

With the *bottom-up join-up approach* the banks are provided with the results of the Asset Quality Review for stress test purposes. The banks then re-work their calculations for certain parts of the stress test. Further top-down adjustments are not necessary.

At first, the ECB favoured a top-down join-up approach. As a compromise and a practical solution, a hybrid approach is now being pursued. This means the banks would be given the opportunity to take into account material partial results of the Asset Quality Review in the stress test. This procedural method is similar to the bottom-up approach. But the hybrid approach still contains elements that the ECB would be taking into account in the stress test on a top-down basis. We do not think much of this idea either, since with top-down adjustments there is always a risk that the banks will then question the results.

There is also another side to this issue: If the banks are told the results of the Asset Quality Review before the Comprehensive Assessment is completed – for example, for stress test purposes – the question of ad hoc disclosure requirements also needs to be addressed. It would be conceivable, for example, that a bank, when discussing its circumstances with the auditor, will draw conclusions about the results of the Review. But other reasons for this could be the findings in the Policies & Accounting Review Process or the results for the Data Integrity Validation. These are to be discussed with the banks shortly, in order to give them an early opportunity to express their views and so conduct quality assurance but also to prevent subsequent vulnerabilities. According to the ECB's proposals, national supervisors would organise data transfer in such a way that the banks are not exposed to the ad hoc disclosure requirement. It is unclear how that is supposed to be done. Merely stressing the "temporary nature of the results being communicated", as planned and desired by the ECB, may well not be enough. We are on the horns of something of a dilemma. EU legislation is in any event unambiguous and, as mentioned, gives the banks the final decision-making power and responsibility regarding its responsibility to go "ad hoc". Any piece of information that can be classified as "insider information" triggers an ad hoc disclosure requirement. It is up to the banks to assess whether an item of news has the potential to influence their shares prices. A bank could therefore see itself legally compelled to publish partial results of the Comprehensive Assessment before the scheduled publication in October. Neither the ECB nor national supervisors can prevent that. And since the ad hoc disclosure requirements of the Market Abuse Directive (2003/6/EC – MAD) apply in all Member States, this problem affects all banks quoted on the stock market that are undergoing the Comprehensive Assessment. However, not too much importance should be attached to this problem either. This supposed risk exists with any supervisory examination and with the auditing of the annual financial statements, too – it's just that the magnitude and possible domino effects are different in this case. In any case the risk of ad hoc publication cannot be used as an excuse not to discuss and confirm AQR findings appropriately with the banks. This would be short sighted and expose the Comprehensive Assessment to substantial risk.

Now I'd like to venture a brief look into the future. What are BaFin's expectations of the results of the Asset Quality Review for the German banks like? Cautiously optimistic. I do not believe that the review of the 24 German candidates involved will come up with any great surprise. Otherwise, we would have to seriously question present accounting practice and the work of certified public accountants to date – and naturally our own work as well. With all due self-criticism, we know of nothing to suggest that. And please keep in mind: The banks have done

their home work, too. They have raised capital and de-risked the balance sheets significantly over the last 3 to 4 years.

Our expectations of the results of the stress test are somewhat different. The baseline scenario should not throw up any major surprises here either. But it is at least conceivable that some banks will have problems withstanding the

adverse stress scenario.

According to the ECB capital shortfalls identified in the Asset Quality Review and/or stress test baseline scenario are to be covered within six months. Capital shortfalls coming to light in the adverse scenario must be made good by the bank within nine months. For this purpose, as a matter of principle it must use capital instruments of the highest quality. Capital shortfalls identified in the Asset Quality Review or baseline scenarios may as a matter of principle be covered only by CET 1 capital instruments. Only in the adverse scenario AT 1 is eligible, too – subject to tight restrictions.

As far as making capital shortfalls good is concerned, although there is nothing automatic about it. The mere publication of the results will exert enormous pressure of expectations, which will, of course, also trigger a demand for the capital plans of the banks concerned to be implemented. Formally, of course, the banks are not obliged to increase their capital until notice to that effect has been received from the supervisory authority. In my opinion, it has to be the ECB, precisely the SSM that issues the appropriate administrative acts.

In late April 2014, the ECB announced how the banks concerned would have to meet the additional capital requirements. Basically, there are two options: the banks can generate more capital or they can reduce their risk-weighted assets. The ECB – so I expect – will lay down clear requirements. In general, a reduction on the basis of an internal mathematical model or a switch of further portfolios into internal modelling would, according to the ECB's current thinking, be permitted only if these changes were already planned and known to the respective national supervisory authority before the Comprehensive Assessment. That also makes sense, since otherwise the Comprehensive Assessment would not have the desired effect of making the banks "fit for the SSM". Please consider the criticism that "model optimisation" triggered after the 2011 stress test.

But it would also not be helpful if the banks were to run down debts overmuch, for that might trigger a credit squeeze. And that is precisely what the ECB wants to avoid with its monetary policy and what politicians want to avoid, too.

Indeed, considering the current market environment, I assume it is in the best interest of banks to anticipate any capital needs and to make every effort to raise the required capital up front. It is important that holes in banks' capital should be plugged first of all by private funds. Here, too, the ECB's thinking appears to be going in the same direction. If it is not possible to plug the holes with private funds, it is up to Member States to seek to ensure the recapitalisation of the banks before the ECB assumes the responsibility. And that, only if these banks still have a viable future. I therefore welcome the fact that the talks and negotiations in Brussels in the past few weeks have brought clarity: public funds are a last resort only and they come into play only after bail-in of equity and junior debt.

To round things off, the question that still remains open then, of course, is how to deal with banks which fail the Comprehensive Assessment and of which the owners, the capital markets and supervisors think no longer have a viable business model. Should the Comprehensive Assessment be used to bring about a market shakeout before the start of the SSM? When exactly is a business model no longer viable, especially in the case of bigger universal banks that have several main pillars? Questions that are difficult to answer, but questions on which potentially answers need to be found.

Last but not least, I'd like to point out that we need to have national resolution schemes and powers in all SSM countries as soon as possible in order to be prepared for any scenario.

Ladies and gentlemen, for all of us – the NCAs, the ECB, the banks and the broader public – the Comprehensive Assessment is a great opportunity and at the same time a great challenge. I have highlighted a few critical issues here, which we must all work together to resolve. What I would like to see is a deep and fruitful discussion with our colleagues at the ECB and the national supervisory authorities and in fact this is taking place already within the Supervisory Board of the SSM. Together, we will succeed in smoothing the way into the SSM and reaping the fruits of our current efforts.