MOODY'S ANALYTICS

News

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KERSTIN VOELKEL
AVP - Communications Strategist
Moody's Analytics
+44 20 7772 5207
kerstin.voelkel@moodys.com

MOODY'S ANALYTICS: ECB'S ASSET QUALITY REVIEW CRUCIAL TO RESTORING CONFIDENCE IN EUROPEAN BANKING

LONDON, 3 July 2014 — A robust asset quality review (AQR) will be crucial to restoring confidence in the European banking sector that was lost during the financial crisis, according to a new report released by Moody's Analytics.

In the report, "Can the Asset Quality Review Restore Confidence?" Moody's Analytics notes that initial European stress tests in 2010 and 2011 failed to fully restore confidence in the European financial system.

"This time the ECB has to get it right. The AQR needs to be thorough enough to identify any hidden problem assets that could cause issues for European banks in the future," says Christian Thun, Senior Director at Moody's Analytics.

The AQR will examine whether assets held by European banks are valued using proper valuation methods, if their exposures are correctly calculated and collateral values are up-to-date, and whether any assets should be reallocated to a different risk "bucket". The AQR will review more than 150,000 credit files from portfolios representing 58% of the total risk weighted assets (RWA) of the 128 banks participating - a mammoth undertaking for both the regulators and the banks.

Collateral and real estate valuations will be a focus of the review. All real estate values that have not been updated within 12 months will be re-valued according to international standards. Similarly, shipping and aviation assets have to be valued based on industry benchmarks, taking into account specific adjustments where necessary.

Another key challenge for regulators and banks will be the assessment of "level-three" exposures. Valuation inputs for these exposures are unobservable and must be developed using market participant assumptions. Examples include complex OTC derivatives, including structured finance securities, distressed debt and many commercial real estate loans. A lack of information or insufficient modelling capabilities for these difficult to value instruments could increase the risk of misstatements that could have a material impact on a bank's overall common equity Tier 1 capital ratio, the focus of the European Banking Authority's 2014 stress test. Regulatory focus in this area could help reduce the risk of misstatement.

Despite concerns surrounding the execution of previous exercises, Moody's Analytics expects the ECB's comprehensive assessment to help boost confidence in Europe's financial sector thanks to a more in-depth “three–pillar approach”. The combination of the initial supervisory risk assessment completed in February, the ongoing AQR and the concluding stress test are likely to provide a more complete picture of European banks’ health than previous stress tests.

“The combination of the AQR and the subsequent stress test should help highlight potential weaknesses in the European banking industry and help minimize the chances for unpleasant surprises in the future,” adds Thun.

For more information, visit Moody’s Analytics Stress Testing.

About Moody’s Analytics

Moody’s Analytics helps capital markets and risk management professionals worldwide respond to an evolving marketplace with confidence. The company offers unique tools and best practices for measuring and managing risk through expertise and experience in credit analysis, economic research and financial risk management. By providing leading-edge software, advisory services and research, including proprietary analyses from Moody’s Investors Service, Moody’s Analytics integrates and customizes its offerings to address specific business challenges. Moody's Analytics is a subsidiary of Moody's Corporation (NYSE: MCO), which reported revenue of $3.0 billion in 2013, employs approximately 8,500 people worldwide and has a presence in 31 countries. Further information is available at www.moodysanalytics.com

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