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Can the Asset Quality Review Restore Confidence?

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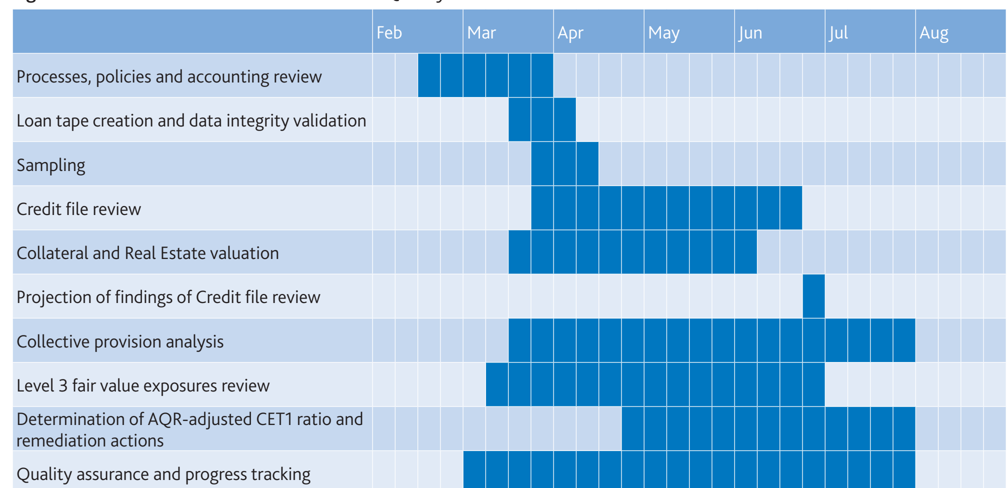
On October 23, 2013, the European Central Bank (ECB) announced the start of its comprehensive assessment in advance of the supervisory role it would assume in November 2014. The key building block of the exercise is the asset quality review (AQR). The AQR aims to assess whether the assets held by the banks in Europe are properly valued, their exposures are correctly calculated, the collateral values are up to date, or whether these assets should even be reallocated to a different risk bucket. More than 150,000 credit files will have to be reviewed from portfolios that represent 58% of the total risk weighted assets (RWA) of all 128 banks participating.[1]

The goal of this mammoth undertaking is to restore confidence in the European banking sector that was lost during the financial and euro crisis and which could not be restored by the initial European stress tests in 2010 and 2011.

The AQR comprises ten so-called work blocks that are scheduled to be executed on-site between February 17 and August 1, 2014.[2] The lion's share of the AQR work is concentrated around the on-site credit file review (work block four) and the collateral and real estate valuation (work block five) as well as the collective provision analysis (work block seven) and the valuation of level-three exposures (work block eight). Figure 1 illustrates the expected timeline of the ten work blocks.

Figure 1: Timeline and work blocks of the Asset Quality Review



It is interesting to take a closer look at the four key work blocks and compare them with similar exercises carried out recently in Greece, Spain, Cyprus, Portugal, or Slovenia.

1 European Central Bank, Press release, *ECB publishes manual for asset quality review*, 11 March 2014.
2 European Parliament, Briefing, *SSM comprehensive assessment of selected euro area banks*, 10 April 2014.

Credit File Review

Following the selection of credit files (work block three – Sampling), the credit file review aims to provide information about potential misclassifications of loans or the under/over-provisioning of sampled exposures. It will be carried out in three steps:

1. Prepare the credit file review
2. Review if exposures have been properly classified
3. Determine if individual impairments and provisioning levels are appropriate given the status of the debtor

This fourth work block of the AQR is an exercise similar to the one during the asset quality review and bottom-up stress test performed by the Banca de España in the summer of 2012. During the Spanish asset quality review, more than 16,000 credit files from the 14 largest banking groups were reviewed by auditing firms. It was found that, for example, a large number of real estate developer exposures were misclassified as SMEs, or that restructured loans were not properly classified as defaulted assets.[3]

In order to understand whether the observed findings in the sample are representative of the wider banks' portfolios, the observed misstatements will be projected to estimate their impact once the credit file review will have been completed.

Collateral and Real Estate Valuation

Also, similar to previous asset quality reviews, one key focus of the ECB's credit file review is the collateral and real estate valuation. Its aim is to ensure that the values of physical assets (e.g., real estate, aircraft, ships, and artwork) used in the assessment of provisions or carrying values on balance sheet assets are appropriate. Real estate values that have not been updated within the last 12 months need to be re-valued according to international standards. Shipping and aviation assets should be valued based on industry benchmarks while taking into account specific adjustments where necessary. To get an idea of the magnitude of this work block, it is interesting to look once more at the Spanish asset quality review in 2012, where approximately 1.7m housing and 8,000 more complex asset valuations were conducted by third-party appraisal firms in order to guarantee that collateral values reflected realistic market pricing. These updated appraisals were later used in the stress testing analysis.[4]

Collective Provision Analysis

The work block that covers the longest period of time (March 14 – August 01, 2014) is the collective provision analysis. In this work block, the ECB aims to assess whether the banks' models for collective provisioning of smaller, homogeneous, and impaired exposures are aligned with the letter and spirit of accounting principles and whether they are properly calibrated. To quantitatively check the calibration, so-called 'challenger models' will be developed by the national competent authorities (NCA) on point-in-time data and applied to the bank's current portfolio. The results will be compared to the current provisioning levels to challenge the banks' models calibration. Deviations will most likely arise due to the fact that a bank's internal model is not always capable of delivering point-in-time estimates as required by the EBA in their methodological note for the EU-wide stress testing exercise.[5]

3 Banco de España, *Asset Quality Review and Bottom-Up Stress Test Exercise*, 2012, p. 25.
4 Banco de España, *Asset Quality Review and Bottom-Up Stress Test Exercise*, 2012, p. 14.
5 European Banking Authority, *Methodological Note EU-wide Stress Test 2014*, p. 21.

Level 3 Fair Value Exposures Review

The level 3 fair value exposures review (work block eight) commenced around the same time as collective provision analysis. This review is focused on assets in the banking book and trading book that are classified as level 3 within the IFRS 13 fair value hierarchy. The hierarchy is based on the observability of the inputs to measure the fair value. Level 3 assets are those where the inputs for the valuations are unobservable and have to be developed using market participant assumptions. Examples of financial instruments that fall into this category are more complex OTC derivatives, distressed debt, illiquid asset-backed securities, illiquid CDOs (cash and synthetic), private equity placements, many commercial real estate loans, and illiquid loans in general.

The review will comprise three elements to assess different aspects of the level 3 exposures.

1. A revaluation for material non-derivative assets potentially resulting in deductions from available capital
2. A qualitative review of the core processes around the trading book
3. A review of the derivative pricing models which will assess the robustness of the models – identified derivations could lead to further deductions from the available capital

The challenge for the banks, the NCAs, and the independent valuation teams, is that pricing models for level 3 assets need to incorporate a wide range of inputs and adjustments that must be embedded in the prices of these financial instruments. This includes, for example, interest rates, credit spreads, yield curves, exchange rates, prepayment options, volatilities, servicing cost, and asset correlations. Lack of information or sufficient modelling capabilities could cause unnecessary deviations, leading to misstatements of positions that may have a material impact on a bank's overall common equity tier 1 ratio, which is used in the EBA 2014 stress test (work block nine).

Restoring Confidence in the European Banking Sector

The objective of the ECB's comprehensive assessment is to restore confidence in the European banking sector. A key building block towards this goal is the AQR. Through the consistent review of assets and the application of standard accounting rules and definitions across the 128 banks in the euro zone, the ECB aims to provide the necessary clarity on the banks that will be subject to its direct supervision from November 2014 onwards.

Can the ECB achieve its goal with the AQR? Looking at previous asset quality reviews (e.g., in Spain or Slovenia) there is room for doubt. The Spanish asset quality review and stress test in 2012 did not restore confidence as it was criticised for making rosy assumptions, resulting in half of the 14 banks tested not requiring additional capital.[6] The review and stress test in Slovenia left the banking sector vulnerable in the eyes of investors, as well.[7]

Despite the moderate success of previous exercises and the concerns that have already been raised with regards to the execution of the AQR, the ECB should be able to restore confidence in the European banking sector. It has chosen a comprehensive approach, including 128 European banks in the exercise. The combination of the AQR and the subsequent stress test as the third element of the comprehensive assessment should highlight potential weaknesses in the European banking sector with a high degree of certainty; thus minimising the chances for unpleasant surprises as experienced after the European stress tests in 2010 and 2011.

6 Reuters, *Spain adds bank stress test to saga of missteps*, 01 October 2012
7 The Economist, *Slovenia remains vulnerable*, 12 December 2013

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2. **European Banking Authority**, *Methodological Note EU-wide Stress Test 2014*, 29 April 2014.
3. **European Central Bank**, *Press release, ECB publishes manual for asset quality review*, 11 March 2014.
4. **European Central Bank**, *Asset Quality Review – Phase 2 Manual*, 2014.
5. **European Parliament**, Briefing, *SSM comprehensive assessment of selected euro area banks*, 10 April 2014.
6. **Reuters**, *Spain adds banks stress test to saga of missteps*, 01 October 2012.
7. **The Economist**, *Slovenia remains vulnerable*, 12 December 2013.

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