
AFME comments on the Asset Quality Review and Stress Test exercise

4th March 2014

The Association for Financial Markets in Europe (AFME) represents a broad range of participants in European wholesale financial markets. Our membership includes a large number of banks engaged in cross-border business in the EU Single Market, having headquarters in the Eurozone, in the EU more broadly or in third countries. A significant number of our members are subject to the Asset Quality Review (AQR).

AFME continues its strong commitment to constructive contribution to the successful establishment and implementation of Banking Union and to the enhancement of the Single Market in financial services.

We are strongly supportive of the objectives of the AQR and Stress Test exercise. They are a key aspect of the successful implementation of the Single Supervisory Mechanism (SSM) and Banking Union more generally, as well as playing a potentially significant role in economic recovery.

It is important that they are well designed and implemented effectively, with an appropriate level of clarity, quality, and consistency. As part of its commitment to the success of the exercise, and drawing upon the experience of its members, AFME has developed this short submission.

The industry fully recognises that the tasks being undertaken by the ECB, EBA and the national competent authorities (NCAs) are very challenging from a technical, organisational and reputational perspective. It is also noted that the situation can vary across jurisdictions. At the same time, we believe that there are opportunities for improvements which could make a valuable contribution to the overall success of the exercise.

Industry understanding and engagement

A central issue relates to clarity and understanding by industry participants as to the requests and demands that are being made. There are concerns that important parts of the exercise are unclear and not well understood. There is a sense that firms are to a significant extent dealing with a “black box” exercise, which can have the result of hampering its overall effectiveness and quality.

A good level of industry understanding is an important precondition to optimal success of the exercise. Accordingly the further development of a well structured mode of communication and enhanced opportunity for an industry engagement with the thinking underpinning the process is called for.

Mode of communication and industry engagement

There are concerns amongst industry participants that the channels of communication between the ECB, NCAs, consultants and firms are in need of enhancement. The complicated nexus of relations means that gaps and delays in communications can arise.

Communication with firms should be as timely as possible, so that a message/request that goes from the ECB to an NCA then is received as quickly as possible by the relevant firms. This is important to ensure that relevant recipients receive messages in a uniform, timely manner.

It is also important that for every firm there is an individual supervisor who is in a position and authorised to answer the firm's questions quickly, clearly and authoritatively. Given the complicated nature of the process with a nexus of relations between NCAs, ECB and external consultants, it is necessary to have in place behind these individuals a set of arrangements allowing these questions to be answered in this manner.

Design issues

Member firms have raised concerns as to the Challenger model developed by Oliver Wyman, which it is expected to be based on a two points-in-time snapshot approach to assess banks' collective provisions and estimate risk parameters. Firms find this new approach difficult to understand fully and do not feel that they have been sufficiently involved in constructive discussions around its concept and design.

There are concerns, for example, as to the extent to which the two points-in-time approach can be effectively and reliably used to develop a true picture of credit quality. In comparison, when member firms developed their internal credit models under the IRBA approach of Basel 2 in 2006-2007, a minimum depth of 5-year history was typically required by NCAs to obtain regulatory approval. Six years of additional data-gathering have further deepened the statistical sample upon which the internal models of member firms are back-tested. Furthermore this approach could lead to inconsistencies and material disadvantages for banks that adopt a 'through-the-cycle' approach to risk parameters such as LGD and PD and apply those in loan provision assessments.

It can also create perverse incentives. For example, a bank that during 2013 has dedicated a lot of efforts on provisioning or impaired/forborne identification, to be well prepared for the AQR, at the end can find itself in a worse position than other banks that did not do the same, because its default rates during 2013 were worse.

Clarity on this matter would be particularly beneficial before the beginning of the on-site phase in the coming weeks.

The methodology of guarantees/credit protection mechanisms assessment should also be clarified, in order to be consistent with the recommendations of EBA and with European regulations. The chosen methodology should be proportional to the estimated risk and should not create excessive and inappropriate reliance on external expertise. In this respect, generic legal opinions regarding transactions of a similar nature using identical credit protection mechanisms (in particular for non cross-border transactions) should be accepted. In the same way, internal legal opinions should be taken into account, as long as they are produced in an independent manner.

Existing European regulations should constitute the basis of the AQR exercise. It gives rise to significant problems and difficulties to draw upon rules that are not yet entered into force.

Data requests

It is essential that firms have reasonable notice of data requests in order that they can be dealt with well and without causing undue disruption to the firm's operations. Data requests that are not optimally judged can ultimately take away from the integrity of the data and from the coherence and ultimate success of the exercise. An approach whereby the data requirements are less ambitious at the outset and the level of detail and granularity is built incrementally over time might be preferable. Moreover, any additional demand for data should be well-assessed and if considered necessary,

addressed with a new extension of the deadline. The iteration of successive demands in a very short time could be detrimental to the good quality of the assessment.

Firms highlighted that the requested information apparently compiles heterogeneous national specificities. It is important to manage this variety of practices, to reduce the risk of creating artificial information without real foundation. For example, the request for the decomposition by file of the accounting collective provisions is not usual in a number of European countries (not an IFRS rule) whereas it seems to be common practice in some.

It should also be noted that data requests in the framework of the AQR seem to include the use of new axis of analysis and new concepts that are yet to enter into force in the reporting templates. These had to be implemented very quickly and with little time for quality assurance.

For example:

- The banking book template and loan tape use the concepts of forbearance and performing/non performing status on the basis of the EBA definition published in autumn 2013. The first application of that ITS will be in the FINREP reporting as of 30 September 2014 (due on 31 December 2014);
- The banking book template uses a new segmentation of clients and exposures, which does not correspond to risk sectors, or to the European NACE codes, requiring manual work and raising doubts on what exactly to report under what line;
- The trading book template requires that notional amounts and valuations as at 31 December 2013 be reported by revaluation model and IFRS 13 level hierarchy;
- In respect to real estate, recent templates require 13 asset classifications and nearly 200 criteria, including future works. These criteria do not reflect the current risk assessment methodology of banks.

As such, given the novelty and uniqueness of this process, supervisors should show a reasonable degree of flexibility as regards the timing of requests for data.

Timing and deadlines

Due to the size and scope of the AQR exercise and in view of the number of portfolios analyzed, the size of samples, the granularity of information, the number of institutions involved and various time constraints, it is important to reach an optimal balance between quality and timing. Deadlines overall are considered to have been unduly tight up to this point and to be liable to give rise to mishaps between the ECB, NCAs and firms.

For example:

- The trading book template was remitted to firms in some jurisdictions on Friday 14 January for reporting by Friday 31 January (it later became clear that the ECB deadline was Friday 7 February). On Wednesday 29 January an updated trading book template was provided: cells to record sensitivities of portfolios had been blocked to record positive numbers only;
- The trading book template, guidelines and the FAQ subsequently received, indicated the scope for reporting was held for trading portfolios. Firms in some countries registered a lack of clarity regarding the inclusion of Available For Sale portfolios, with firms in the same jurisdiction being given contrasting information on the AFS inclusion;

Firms' right to be heard and right of response

We believe that the right for firms to be heard after the on-site inspections should be detailed and guaranteed. A firm's formal answer should be inserted at the end of the inspection report.

A sufficient delay should be given to prepare the firm's formal answer and for the ECB to take it into account. For complex cross-border groups, a methodological exchange on data could be organized before the start of the on-site inspections.

Outcomes

Firms have raised issues related to the outcomes of the exercise and the lack of clarity around a number of aspects. There seem to be two key aspects of concern, related to i) compliance with local GAAPs and/or IFRS and ii) the timing with publication of audited financial statements.

On the first point, it appears that there will be an issue if there are requirements for adjustments to a bank's accounts that are not compliant with the accounting standards the bank applies (e.g. too conservative provisions, or impairment for losses that have not yet occurred). Concerns relate to the risk of needing to book P&L adjustments that may not be, for example, IFRS compliant.

On the second point, most banks will close, approve and publish their financial statements around February/March 2014. It is unclear what will happen in case it emerges that some banks' assets are considered significantly over-valued as at 31 December 2013: will the ECB communicate those conclusions after the publication of the financial statements, and will banks have to re-state their 2013 accounts? It is also unclear what will be the possible role of auditors in this framework and the reaction of the markets to such announcements.

Exercise risks and risk management

All parties involved in the AQR should maintain the highest degree of confidentiality throughout the whole exercise. This is particularly important given the market sensitivity of the data used and produced. Non disclosure agreements – with standards equal those normally proposed by national authorities - should be signed by external consultants.

It is very important that transparency, consistency and sound internal and external communication between ECB, EBA and NCAs are maintained throughout the conduct of the AQR and stress tests, and after their completion. A patchy, inconsistently communicated outcome would be detrimental to market confidence and to European financial markets.

Clear communication to the market should be carefully maintained. In this regard, rating agencies, bank analysts and other market players must have a proper understanding of the exercise and avoid therefore erroneous conclusions. Communication with the market authorities will have to be well coordinated in order to avoid the creation of different levels of information.

Stress Tests and linkage with AQR

On stress tests, there should be consistency of approaches across different jurisdictions - close cooperation and effective coordination are essential elements in this context. It is important that further details on the stress test exercise are communicated as soon as possible. This would enhance certainty and allow the industry sufficient time for preparations.

Coordination amongst supervisors on stress testing would enhance the quality and credibility of stress test outcomes, and avoid contradictory capital adequacy assessments. Coordination should be considered in relation to many different dimensions of stress testing, including timing, stress severity, capital planning, and remedial actions.

As regards the relationship and interaction between stress testing and AQR, full coordination and consistency of approaches between ECB and EBA should be ensured and maintained throughout the exercises and beyond. This should apply to all aspects of the endeavour, including methodologies, actions, organisation and communication. In its latest note on the comprehensive assessment, the ECB states that for the stress test component of the comprehensive assessment, the ECB will cooperate closely with the EBA, and will apply the methodology and parameters agreed and announced by the EBA, adding that the stress test for the SSM countries will, in addition, incorporate the results of the on-going AQR. The link between AQR and stress test should be clarified as the former was supposed to be the baseline for the latter - but that should be compatible with the new timelines which are now overlapping.

On the stress test's baseline and adverse scenarios, the ECB has also clarified that commonly agreed EU-wide baseline and adverse scenarios will be developed by the European Systemic Risk Board (ESRB), in close collaboration with the ECB and the EBA, as in previous exercises

Managing requirements for additional capital or failure

Clarity is needed as to the process, timing and consequences of failure of the AQR and/or stress tests.

A formal dialogue between the supervisor and the supervised institution should be set up at two different stages: i) a methodological exchange at group level before the start of the inspections on site, to make sure that the data given to the supervisors are well understood; ii) a dialogue process in case of problems identified by the supervisor after the inspection and before the release of the results.

Any requirements for banks to raise additional capital should be met, where possible, through private means including raising new capital, deleveraging/restructuring and/or retaining earnings. The exercises should be designed to provide banks with sufficient time to carry out a plan to restore their capital ratios, including implementing their recovery plans where appropriate, taking into account the impact of requirements on other banks arising out of the exercise. The possibility of multiple banks having to raise large amounts of new capital concurrently within a short timeframe should be minimised through the design of the process and providing sufficient time for banks to remedy any shortfalls.

A consistent approach to dealing with any capital shortfalls should be taken throughout the EU. The EBA/national and ECB processes should therefore be aligned as far as possible. In particular it is essential that the process and communications are coordinated, particularly in relation to cross-border banks to avoid mixed messages regarding a single group.

Where a bank meets the conditions for resolution i.e. (a) it is failing or likely to fail; (b) there is no reasonable prospect of an alternative private sector or supervisory action that would prevent its failure in a reasonable timeframe; and (c) it is in the public interest for it to enter resolution (each as set out in the BRRD), it should be resolved, in line with the recovery and resolution framework.

Where a bank is found, *following an asset quality review*, not to meet its existing minimum regulatory capital requirements and is unable to remedy this without state intervention, the bank is likely to be non-viable and where appropriate should enter resolution.

A different situation arises where a bank is found to meet its existing minimum regulatory capital requirements, but is required to raise additional capital as a buffer *following the completion of the stress tests*. Clarity is required as to precisely what the competent authority will be requiring of the bank in such circumstances, particularly regarding process and timeline, and the consequences for failure to do so within the set timeframe. This is important to ensure an appropriate balance between the need for a targeted approach reflecting each bank's particular circumstances and a level playing field so that all banks in similar situations are treated similarly.

It is also important that the EBA's bank-by-bank disclosure (based on the common ESRB scenario) will not be overshadowed by individual banks' disclosing their own results based on the common ESRB scenario adapted for national specificities by NCAs. Moreover, AFME stands ready to assist policy-makers in the preparation of the disclosure template, for example by commenting on it in due time.

When applying any burden-sharing requirements arising from the EU state aid rules or under a resolution framework, it is vital that the NCWOL principle, as incorporated in the BRRD and EU state aid guidelines, be upheld. In practice this is likely to limit the losses that can be imposed on shareholders and creditors, particularly where a bank meets its existing minimum capital requirements.

The proposed timeframe involves announcing the results of the AQR and stress tests in November 2014 and there is likely to need to be a period to allow banks to raise capital privately before resolution being initiated. Therefore the BRRD, which comes into force at the beginning of 2015, should apply to banks which need to be resolved following the expiry of any such 'grace' period for private intervention.

Third country issues

At this stage it is largely unclear how cooperation with third country authorities, particularly from non-EU member states, will work. Related to this, firms are under the impression that there seem to be problems of coordination/communication between the ECB and some third countries' NCAs. This aspect is particularly important for firms with a highly geographically diversified business model.

It is also important to ensure that third countries authorities treat secrecy and confidentiality in the same way as the ECB and banking union NCAs, particularly as regards the treatment of confidential information, the conduct of on-site inspections etc.