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The ECB's health-check of the banks – a necessary but not sufficient step for reforming the euro

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Abstract:

The reform of the euro launched in June 2012 is based on two main points: the strengthening of economic governance and Banking Union. The latter is twofold and comprises – centralised supervision by the ECB and an innovative crisis management mechanism. Before taking on its new tasks the ECB undertook a health-check, unprecedented in terms of its scope, of the banks in the euro zone in order to consolidate the sector, restore confidence and to foster the reactivation of credit. This paper analyses how this exercise was undertaken before assessing its quality and seeing what is to be learnt from it, both regarding the banks' situation, as well as the issues and challenges raised by the new supervisory mechanism. The "truth" operation undertaken by the ECB has been successful on the whole since it has strengthened the institution's credibility and augurs positively for the continuation of Banking Union. However the latter will only be able to take full effect with the strengthening of the second foundation of the reform of the euro, i.e. with the introduction of a kind of economic government that has the capacity to play a safety net function for the guarantee mechanisms of Banking Union – via a budget – and to start a powerful programme to bring the euro zone out of stagnation.

A DECISIVE STEP TOWARDS BANKING UNION

The complete reform of the Economic and Monetary Union, started by the European Council of June 2012 in response to the euro crisis and to guarantee its survival, is based on two pillars: the reform of economic ***governance*** and Banking Union [1]. The latter's foundation mainly lies in the Single Resolution Mechanism for solving banking crises adopted at the end of the preceding legislature and the Single Supervisory Mechanism, which establishes the European Central Bank (ECB) as the single supervisor of the banks in the euro zone [2]. The ECB, which was given these new powers on 4th November 2013, launched a major operation, qualified as a "Comprehensive Assessment" as part of the preparatory work planned for in the regulation [3]. The latter aimed to check the health of the euro zone's banking sector, followed by corrective measures if necessary, prior to the effective assumption by the ECB of its new powers on 4th November 2014.

In this unprecedented exercise – in terms of both its range and the depth of its investigations - the ECB's executive, which is pursuing goals of transparency, balance sheet consolidation and confidence strengthening [4], face two decisive challenges.

On the one hand it involved establishing the ECB's credibility in its role as single supervisor. In this capacity it has to work with the European Banking Authority (EBA) [5] and the National Competent Authorities. The person responsible for single supervision, Danièle Nouy, summarised this challenge quite clearly: "We know we have a single opportunity to establish our credibility and reputation" [6]

On the other hand the banking sector has to be strengthened for two reasons:

• Firstly the recovery of the banks' health conditions the reliability of the future Single Resolution Mechanism (SRM); indeed the more drastic the adjustment implemented by the "truth" operation now, the less probability there will be of ulterior bank default which would require the SRM assistance;

1. *Dominique Perrut, "The Reform of the Economic and Monetary Union : political ambition or division, European Issues n°297, Robert Schuman Foundation, 16th December 2013*

2. *Regulation on the Single Supervisory Mechanism EU 1024/2013 of the Council of 15/10/13 granting the ECB with specific tasks.*

3. *Regulation SSM, art. 33 (4).*

4. *ECB, Aggregate Report on the Comprehensive Assessment, p. 13.*

5. *The European Banking Authority is one of regulation and supervision notably comprising a college of 28 national bank supervisors. The EBA was created in 2010 (Regulation (EU) 1093/2010). Its regulation was changed as part of the SSM : EU Regulation 1022/2013 of 22/10/2013 modifying regulation 1093/2010 establishing the European Banking Authority.*

6. *"ECB super-regulator prepares to be unpopular", Financial Times, 10th February 2014.*

• Secondly the banks' capacity to lend to the economy has to be restored. In spite of massive ECB liquidity injections into the banks since the end of 2011, lending to the economy has continued to decline in the euro zone. The decline totalled 5.5% from the end of 2011 to August 2014. This collapse has been all the greater for business: 9.1% less. This reduction is partly due to the banks' fragility. The strengthening of the banks is therefore a condition for credit reactivation. But the supply of loans also has to match demand from the economy, and this, after two years of slight contraction, only made a feeble recovery in 2014 [7].

1 – THE COMPREHENSIVE ASSESSMENT

1.1 – Scope and organisation

Scope

It was decided to limit this exercise to the so-called "banks of significant importance", which matched the following criteria [8]:

• Banks whose total assets were in excess of 27€ billion (which provides an order of magnitude of activity) which is quite a low threshold equal to an average sized European regional bank. The groups were retained according to the highest level of consolidation in the country [9];

• In each Member State the three most significant banks (three Slovakian banks and 2 Slovenian banks);

• Banks whose total assets were over 20% of the GDP of the country where they are established (Estonian, Cypriot and Maltese banks);

• Banks with high cross-border activities (2 Austrian banks and one Belgian bank);

• Banks that have requested or received public financial assistance from the Union [10].

A total of 130 banks or banking groups matching these criteria, representing 81.6% of the euro zone's banking assets, i.e. 22, 000 billion € (around 24% of the world's banking assets [11]) were the focus of the Comprehensive Assessment, before coming, in their majority, under the direct supervision of the ECB [12].

Organisation

The Comprehensive Assessment, which started in November 2013, involved the ECB, notably assisted by the consultancy Oliver Wysman and the National Competent Authorities, which were also assisted by external groups. It is estimated that 5,000 external experts worked on the operation. Joint teams comprised ECB auditors and national supervisors.

In addition to this the banks which were subject to this exercise turned out sizeable teams to respond – not without some tension - to the numerous requests made by the supervisors. It is estimated that more than 500 employees were requested on these tasks in some leading banks.

Finally the European Banking Authority, the Union's regulator and supervisor intervened to provide the ECB with certain technical standards in view of harmonising supervisory rules and practices and to undertake stress tests together with the latter.

1.2 – TWO MAJOR PHASES IN THE COMPREHENSIVE ASSESSMENT

A – Asset Quality Review

This stage occurred after a preparatory phase, qualified as the Supervisory Risk Assessment, comprising the qualitative and quantitative assessment of major risk factors, notably linked to liquidity, leverage and financing.

Extremely ambitious in terms of its goals since it reviewed more than half of the weighted assets of the banks selected [13], i.e. 58% equal to 3,720 billion €, the Asset Quality Review aimed to assess, according to uniform methodology and harmonised definitions, the balance sheets of the selected banks on the basis of their accounts ending 31st December 2013. During this exercise the outcome of which focused more on prudential (pinpointing risks) than accounting aspects, supervisors were supposed to:

• Assess the valuation of assets and that they fell in line with the rules in force;

• Check that non-performing loans and other exposures were correctly classified and identified and, as a result, ensure that enough provisions had been made given these impaired assets;

• Finally assess the valuation of complex instruments and high risk assets particularly arbitrage exposures

7. GDP in volume of the euro zone : - 0.7% in 2012; - 0.4% in 2013 (Source: Eurostat); 0.8% in 2014 (forecasts).

8. Decision of the ECB of 4th February 2014 identifying the credit institutions that are subject to the comprehensive assessment (ECB/2014/3); ECB: The list of significant supervised entities and the list of less significant entities, 4th September 2014.

9. Consolidated accounts present, according to existing regulation, the accounts of a group of companies that depend on the same parent company as if they formed one single entity with the parent company.

10. This means aid granted by the European Stability Mechanism (ESM) which followed on from the European Financial Stability Facility.

11. Calculated according to IMF data (Global Financial Stability Report, October 2014, p. 163).

12. Direct supervision will apply to 120 banks to which we might add 8 banks that were not part of the truth operation whilst some that took part will not be subject to direct supervision. Cf. ECB, Aggregate Report on the Comprehensive Assessment, 9.1, p. 141.

13. Risk-Weighted Assets comprise all bank exposures addressed according to the level of risk defined by the rules in force set by the CRD IV Directive (Directive 2013/36/EU, 26th June 2013) and the CRR Regulation (Regulation (EU) No 575/2013, 26thJune 2013) in the Union, transposing the international Basel III standards set by the Basel Committee notably to define the ratio of capital requirements to which banks are subject.

(from the trading book) which are reputed to be difficult to assess. Amongst the latter feature the so-called "level 3 fair-value" exposures have come under particular scrutiny (see hereafter) [14].

At the end of the exercise the differences with the accounts published at the end of 2013 resulting from these assessments were supported by the banks' equity the core of which (or Common Equity Tier 1, CET1) should, after adjustment, be higher than the required minimum set 8% of the risk weighted assets [15].

The review comprised three stages:

• The definition of the sample of portfolio to be assessed: 800 portfolio were selected matching 119,000 debtors. These portfolio were supposed to represent at least half of the credit risks of each bank being reviewed;

• The execution of the review which was undertaken by joint ECB and national supervisor teams;

• The compilation of data, which entailed a quality assurance procedure, a comparative analysis and a final centralised assessment. We should note that based on the adjustments made to the portfolio analysed, forecasts were made in order to adjust the portfolio that were not reviewed.

The accounting framework corresponded to the international standards adopted by the Union, i.e. the IFRS [16]. However national standards were admitted in certain cases. Moreover in order to remedy the disparity between national supervisory practices the EBA's work was used, in particular for the vital definition of non performing exposures and forbearance. The EBA's standard was simplified by the ECB [17]. This did not guarantee total homogeneity but did provide however "a reasonable degree of standardisation" [18].

The rules pertaining to the definition of "fair-value" were also defined, notably regarding Level 3 fair-value assets, the only ones to enter within the scope of the Asset Quality Review [19]. These are assets that are only assessed according to models based on non-observable parameters. Regarding level 3 fair-value the harmonisation work remained modest it seems but it did however lead to significant adjustment notably in the case of the French banks.

B - Stress test

Unlike the AQR which was designed to validate or where necessary adjust the last accounts published at the end of 2013, the stress tests aimed to assess the banks' capacity to absorb hypothetical future external shocks in the event of a crisis. The integration of these two exercises undoubtedly comprised an innovative feature and one of the major strengths of the Comprehensive Assessment. Indeed it was the result of the AQR, leading to the adjustment of the published accounts, which served as a starting point for the stress tests.

These were undertaken and coordinated by the European Banking Authority (EBA) in virtue of one of its powers [20]. The EBA was responsible for establishing common methodologies and scenario and for centralising results in standardised templates. The operation was undertaken jointly with the ECB (as part of the Comprehensive Assessment) and the national supervisors in the non-euro zone States. It was the supervisors' responsibility (ECB and other national authorities) to validate the test results communicated by the banks.

Two macro-economic scenarios were established. The first was a baseline scenario provided by the Commission based on its standard economic forecasts for the period 2014-2016. The Union's growth, like that of the euro zone is forecast to lie between 1% and 2%.

Based on this the European Systemic Risk Board (ESRB) established hypotheses of the emergence or downturn in four systemic risk situations (long term increases in bond yields, worsening of credit quality, stalling in structural reform and the lack of bank balance sheet repair) to draft an adverse crisis scenario. The latter notably forecasts a GDP level that is 6.6% less in the euro zone in 2016 in comparison with the Commission's baseline scenario, with an unemployment rate of 13.5% in the same year (against 11.3% for the baseline scenario). According to the adverse scenario euro zone housing prices would drop by 15% in 2016, i.e;

14. *This phase only concerns a sub-part of the sample which deals significantly in arbitrage operations.*

15. *The Common Equity Tier 1 comprises shares and assimilated funds as defined on 1/1/2014, given the transitory agreements. The ratio is calculated by matching this capital against risk-weighted assets.*

16. *The IFRS, includes in particular for the banks the standards IAS 39, 37 and IFRS 13.*

17. *This is a simplified version drafted as part of the AQR, of the Implementing Technique Standard published by the EBA on 21st October 2013 and which entered into force in September 2014.*

18. *ECB, Aggregate report on the Comprehensive Assessment, p. 65.*

19. *Idem, p. 168*

20. *2010 EBA regulation, article 32.*

21. *(ERSB):EBA/SSM stress test: The macroeconomic adverse scenario, 17th April 2014.*

a difference of 19% with the baseline scenario [21]. The banks subject to the stress tests have to transfer the effects of these two scenarios into their accounts according to a methodology that is as precise as it is complex and by calculating their impact on each of the following risk categories: credit, market, securitisation, sovereign exposure, cost funding and interest income [22].

After the stress tests the banks were to present a minimum capital threshold (after adjustment cuts undertaken by the AQR) of 8% for the baseline scenario and 5.5% for the adverse scenario.

These stress tests were undertaken across the whole Union. They involved 123 banking groups in 22 of the Union's countries representing 28,000 billion € in assets i.e. 70% of the banking assets, notably including – the euro zone groups apart – four British, 6 Polish and four Swedish banks.

The join-up of the Asset Quality Review and the stress tests was undertaken according to a methodology that included a contradictory discussion between the ECB and the banks involved. As of October "prudential dialogue" over the results was introduced. For each of the banks reviewed this dialogue brought together ECB members (including the joint supervisory teams [23]) the national authorities and the supervised banks.

2 – RESULTS AND CORRECTIVE ACTION

2.1 – Assessment of the results

Each bank was the focus of a template notably taking up the impact of the adjustments effected, with a distinction between the results of the AQR from each of the stress test scenario, on capital ratio. These templates have now been published and a relatively fine amount of detail makes it possible to see where the adjustments arose. Moreover overall aggregate results, including details for each of the supervised banks, are provided in an ECB report [24]. The EBA has published a report and analogous templates for the stress tests [25].

Overall for the entire sample of the Comprehensive Assessment undertaken by the ECB, combining the AQR and the stress tests, the impact of the exercise represents a capital depletion of 263 billion € (see figure, Annex 1) of which:

• A total of 216 billion € (i.e. 22% of the capital held by banks at the end of 2013) representing 34 billion € net, in terms of the impact of the AQR and 182 billion € in terms of the effects of the stress test.

• A total of 47 billion €, resulting from the increase in weighted assets linked to activity as part of the stress tests (over the period 2014-2016).

France, Italy and Germany recorded the highest levels of capital depletion, ranging for each country between 46 and 49 billion €, whilst Greece and Spain each saw a capital depletion of 22.5 billion €. These details should be considered relatively according to the various countries' respective weight. The variation in the capital ratio from the beginning to the end of the exercise quite rightly provides a good idea of the comparative resilience of the national systems. Hence with an average reduction of 3.4 capital ratio points (CET 1) which drops from 11.8% to 8.4% across the entire sample, we notice depending on the country that:

• in France there is a 2.5 point ratio decrease with this falling from 11.5% to 9%;

• in Germany there is a greater ratio decrease, i.e. -4 points, declining from 13.1% to 9.1%;

• in Spain, an extremely moderate ratio decline i.e. -1.6 points, declining from 10.6% to 9%;

• in Italy and Greece, countries for which we do not have sufficient aggregate details, the ratio decrease is respectively 4 and 10.9 points, which shows the significance of the impact on Greek banks.

A total of 24.6 billion €, within the overall sum of 263 billion € represented the capital shortfall observed for the banks which lie below the required thresholds. These shortfalls in capital affected 25 banks, notably in Italy (9.7 billion €, in the case of 9 banks [26]), Greece (8.7 billion € in 3 banks), as well as Cyprus (2.4 billion € in 3 banks).

The capital already raised by the banks in question in 2014 totalled 15.2 billion €, which reduced the capital requirements still needed to 9.5 billion €. This concerned 14 banks, notably four in Italy (with a requirement of 3.3 billion €, of which 2.1 billion € for the Banca Monte

22. *EBA: Methodological note EU-wide Stress Test 2014.*
23. *Joint Supervisory Teams.*
24. *ECB, Aggregate report on the Comprehensive Assessment.*
25. *EBA: Results of 2014 EU-wide stress-test, 26th October 2014.*
26. *Of which 4.2 milliards € for Banca Monte dei Paschi*

dei Paschi) and two Greek banks (2.7 billion €, of which 1.8 billion € for the Eurobank).

The gross AQR capital adjustments totalled 48 billion € (i.e. 34 billion € net after tax effects), which corresponded in the main to increases in individual and collective provisions especially in terms of non-performing exposure (43 billion € gross) and to adjustments made by the fair-value review (5 billion €). The gross effect of the AQR depending on the country and the category of adjusted assets notably affected banks in the following countries (see figure, Annex 2):

- Italy, 12 billion € [27], affecting almost exclusively loans portfolio of major companies;
- Greece, 7.6 billion €, affecting loans portfolio of major companies (around 4.7 billion €), but also residential real estate (2.3 billion €);
- France, 5.6 billion €, especially affecting loans portfolio of major companies (around 3.2 billion €), but also adjustments to fair value assets (1.2 billion €);
- Germany, 6.7 billion €, especially affecting major companies.

Following some reclassifications, non-performing loans and other exposures increased in the balance sheets at the end of the exercise by 136 billion € due to the harmonisation of definitions (55 billion €) and the identification of further non-performing exposures (81 billion €). Thus the total stock of non-performing exposures rose from 743 billion € to 879 billion €, i.e. an increase of 18%. The rate of doubtful loans, estimated in terms of the all of the loans portfolio (16,400 billion €) increased in our estimation from 4.5% to 5.4% following the exercise.

2.2 – CORRECTIVE MEASURES

The 14 banks suffering capital shortfalls after the exercise were obliged to submit a recapitalisation plan for 10th November. These plans are supposed to cover the capital shortfalls within six months if they result from the AQR or the stress test baseline scenario and within nine months if they result from the adverse scenario. These programmes are to be assessed by joint supervisory teams (ECB and national supervisors [28], who will follow their implementation.

Recapitalisation in the main is to mobilise private sources, i.e. new emissions which enter into the definition of tier-one equity , CET1, including contingent convertible instruments; so-called additional capital as well as asset sales and retained earnings on 2014 profits are allowed to a certain degree. If these measures prove insufficient the use of the resolution mechanisms and then state aid, closely overseen by the Union are then being planned for [29]. There has been no mention of the possible use of the European Stability Mechanism.

3 – LESSONS AND QUESTIONS

3.1 – A rigorous Comprehensive Assessment

We might be surprised by the low capital shortfall (24.6 billion €) that resulted from the Comprehensive Assessment. In this regard we should remember that measures were taken as soon as this operation was announced in July 2013. Between this date and August 2014 the strengthening in capital in relation to weighted assets totalled 203 billion €, either via increases in equity (136 milliards €), or by assets' sales (67 milliards €). These programmes enabled the banks to prepare for the exercise in better conditions.

AQR is an ambitious complement to the framework of this type of assessment, which often reduced to stress tests. On the basis of a sound methodology and organisation the AQR has led to major adjustments, especially in terms of non-performing exposure, with impact being effected on capital. This operation did however highlight two limits which those in charge themselves acknowledge [30]. On the one hand, although the harmonisation process has moved forwards in terms of non-performing exposure and the appreciation of fair value assets, convergence is far from having been achieved. The introduction of a homogeneous definition of capital for example is on the top of the ECB's agenda. On the other hand, the operation, which focused on financial assets, did not take on board all the risks taken by the banks and notably: the portfolio of level 1 and 2 fair value assets, deemed to be safer than level 3; most of the non-financial assets as well as the liabilities; operational and litigation risks with the corresponding provisions [31].

27. Of which 4.2 milliards € for Banca Monte dei Paschi.
28. "ECB-led SSM Joint Supervisory Teams"
29. Aggregate Report, p. 126.
30. ECB, Transcript of the comprehensive assessment press conference (with Q&A), 26th October 2014.
31. Aggregate Report, p. 39.

Out of the stress tests, from the point of view of their duration over three years – and many contrary parameters that were retained, the stress test scenarios in 2014 were much more stringent than those undertaken in 2009 and 2010 (by the CEBS [32]) and in 2011 by the EBA. Severely criticised, these tests damaged the image of these institutions. The adverse scenario of the 2014 retains a cumulative GDP deviation of 5.1% over two years and 6.6% over three years from the baseline scenario for the euro zone, which is much more restrictive than any previous tests.
It is true that as part of a similar exercise the Federal Reserve introduced a "severely adverse" scenario in 2014 with a GDP deviation of 8.9% from the baseline [33]. It is admitted however that in spite of criticism about the lack of a deflationary scenario or the inclusion of ongoing litigation, the exercise undertaken by the Union in 2014 is closer to the one undertaken in the USA in 2009 just after the crisis, and which is considered to be a reference in terms of its rigour [34].
The Comprehensive Assessment took place in good conditions in terms of transparency. Intermediary notes and methodological manuals were published likewise a report on the results and individual detailed templates on each bank that was examined. Country by country summaries would have been useful, likewise individual data in the report.
In all the exercise has led to an impact on the bank capital ratio totalling 3.4 points thereby bringing the average starting ratio from 11.8% down to 8.4%, i.e. a level in line with regulatory requirements of 8% and well over the minimal level required following the adverse scenario (5.5%). In this sense the banks in the euro zone now appear to be quite resilient and well capitalised.

3.2 – Questions about the functioning of single supervision

The Comprehensive Assessment should lead to the restoration of confidence both in the banking system and the ECB's capacity to undertake its role as the single supervisor. In this sense the exercise supports the project of Banking Union.
Cooperation between the ECB and the EBA seems to have functioned well within the framework of the Comprehensive Assessment. However there are questions surrounding the risks of regulatory division between the euro zone, which comes under single supervision and the rest of the Union, where the national authorities communicate with the EBA, the regulator of the 28 countries, which is often incapacitated by its collegial configuration [35]. The convergence of regulation and supervision between the euro zone and the non-euro zone States remains a challenging issue.
We might also wonder about the type of cooperation that might emerge between the ECB and the national supervisory authorities, notably regarding small banks which do not come under the ECB's direct supervision. German banks which are extremely fragmented [36] are mentioned from this point of view since small regional State-controlled banks are said to have balance sheets replete with bad loans. Which type of protocol does the ECB intend to introduce to ensure the convergence of standards and practices with the national authorities in order to prevent the emergence of regulatory competition within euro zone countries?

3.3 – Economic government – a necessary complement to Banking Union

The reform of the EMU undertaken by the European Council of June 2012 is based on two pillars: Banking Union and the introduction of a type of economic government.
As the ECB effectively takes over single supervision it is supported by the rather successful completion of the Comprehensive Assessment. This operation strengthens the project for Banking Union as a whole but this is however challenged by two limitations.
Single supervision enhances the credibility of the other facet of Banking Union - the financial crisis management mechanisms (Single Resolution Mechanism and the Deposit Guarantee Scheme). In the context of a consolidated, well controlled banking system these may indeed seem to be more viable, since all things being equal they should not be called upon so often. However in order for these instruments to be totally failsafe they need the support of an ultimate financial safety net, which would probably rest on a common budget.
On the other hand the success of the ECB's "moment

32. *Committee of European Banking Supervisors, which preceded the EBA.*
33. *"Comprehensive Capital Analysis and Review", 2014, undertaken by the Federal Reserve.*
34. *The Economist, Stress Relief, p 69, November 1st 2014*
35. *See European Issue n°297, op. cit.*
36. *In September 2014 there were 1,813 banks in Germany, in comparison with 520 in France and 680 in Italy (source: ECB).*

of truth" operation cannot be the only guarantee for the recovery of banking lending to the economy. Apart from bank consolidation this indeed supposes a rise in the demand for financing on the part of a growing economy. From this point of view a powerful initiative for economic recovery is vital to bring the euro zone out of the quagmire in which it has been trapped over the last three years- this initiative might find support in the proposals put forward by the freshly appointed Juncker Commission, notably in terms of investments [37].

Hence Banking Union will not be able to take full effect unless economic government is introduced, which would be able to implement an economic support programme providing – with a common budget – a vital last-chance guarantee to the Banking Union's solidarity mechanisms.

CONCLUSION

According to the in-depth diagnosis of the banks which we can consider to have been successful as a whole, Banking Union is moving forward, mainly thanks to the community method, in line with the agenda to reform the euro.

Following its audacious, unconventional support policies to the economy, notably since 2011, the ECB undeniably emerges strengthened by the Comprehensive Assessment. Although this stage, which supports the project for Banking Union seems to be a necessary condition for the reform of the euro and economic recovery, it is not enough however.

The second chapter in the reform of the euro must comprise the introduction of true economic government. This supposes an institutional renewal to enable the end of intergovernmental stagnation [38], so action can be taken on both fronts. This means undertaking a powerful common policy for revival, which might find support in the proposals made by the Commission led by Jean-Claude Juncker. The stages that will lead to a common euro zone budget still need to be defined. Apart from its function of stabilising the economy, might help to guarantee the mechanisms of solidarity and thereby the viability of Banking Union.

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37. Cf. Olivier Marty, "For the recovery of investment in Europe" European Issue n°325, Robert Schuman Foundation, September 2014.

38. Thierry Chopin, "Reforming the European Union: With which methods? What are the options?" European Issue n°320, Robert Schuman Foundation, July 2014.

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