Box 4

THE ECB'S COMPREHENSIVE ASSESSMENT EXERCISE

The results of the ECB's comprehensive assessment, a thorough and unprecedented examination of 130 euro area banks, were published on 26 October 2014. This box presents the scope, main findings and conclusions of the comprehensive assessment exercise.

Scope of the comprehensive assessment

The exercise was undertaken as part of the preparations for the ECB's assumption of supervisory responsibilities on 4 November 2014. The 130 banks participating in the exercise had total assets of €22 trillion at the end of 2013, accounting for more than 80% of total assets of the euro area banking system.

The comprehensive assessment exercise had two components:

- An asset quality review (AQR) of the assets held by banks at end-2013, in the course of which banks' accounting models, policies and practices were checked on the basis of a common methodology[1] and harmonised definitions across all participating countries.

- A constrained bottom-up stress test, in the course of which banks were requested to project the impact of hypothetical baseline and adverse macro-financial scenarios on their balance sheets and income statements.

The results of both components were joined together using a methodology that adjusted the stress-test results to reflect the findings of the AQR,[2] a unique feature of the comprehensive assessment in comparison with similar stress-testing exercises.

Both components of the comprehensive assessment exercise were subject to a rigorous quality assurance process, comprising banks, national supervisors and the ECB, in order to ensure the appropriate degree of conservatism and a level playing field for all participating banks. The adverse macro-financial scenario for the stress test was designed by the European Systemic Risk Board. It captured the most relevant threats to the stability of the EU banking system that were identified in the spring of 2014, including an increase in global bond yields, a deterioration in credit quality, stalling policy reforms that lead to a re-emergence of sovereign risk and a lack of the balance sheet repair necessary to sustain market funding at affordable rates. Overall, these risks still remain relevant to date. The comprehensive assessment was a prudential exercise. By design, its scope did not include some of the macro-prudential risks related to, for example, the interconnectedness of participating banks or second-round effects arising from banks' endogenous response to macro-financial stress.

Main findings

The comprehensive assessment concluded that most of the euro area banks would be resilient under the adverse macro-financial scenario in spite of a significant depletion of their capital.

1 See *Asset quality review – Phase 2 Manual*, ECB, March 2014.
2 See *Comprehensive assessment stress test manual*, ECB, August 2014.

The Common Equity Tier 1 (CET1) capital of the participating euro area banks would be reduced by €216 billion (see Chart A), €34 billion of which is due to the adjustment made in the course of the AQR, and €182 billion to the losses projected in the adverse scenario of the stress test.[3] In addition, the minimum capital requirements would rise by €47 billion as a result of the increase in risk-weighted assets.

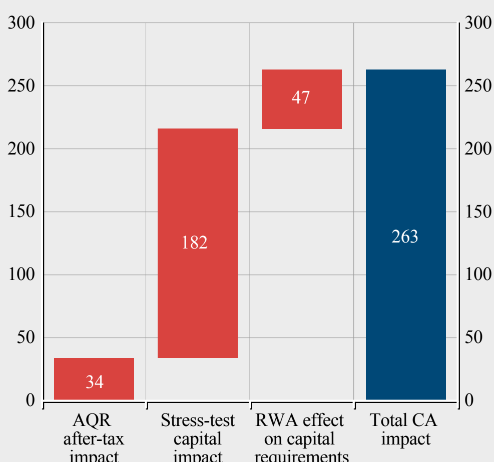
It was found that 25 euro area banks did not have sufficient capital to meet the CET1 capital ratio requirements specified for the comprehensive assessment exercise of 8% for the baseline and 5.5% for the adverse scenario. The total capital shortfall amounts to €24.6 billion prior to mitigating actions taken after the end-2013 reference date.

The AQR concluded that, under the common methodology and harmonised definitions, the non-performing exposures (NPEs) of participating banks should increase by €136 billion, or 18%, with respect to the stock of NPEs reported at the end of 2013. The review of impairment provisions related to both NPEs and other assets found that banks would mark down their assets by a further €43 billion on a pre-tax basis.

The baseline scenario of the stress test entailed an only slight increase in the CET1 capital ratio, reflecting the subdued operating profitability of participating banks. Under the adverse scenario, loan losses would nearly double with respect to the baseline case, and net interest income would contract by about 10%. A somewhat less material contribution to aggregate losses came from

Chart A Total impact of the adverse scenario of the comprehensive assessment on capital

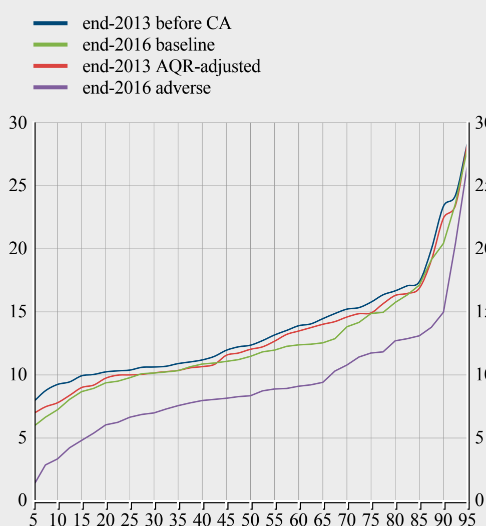
(EUR billions)



Source: ECB.

Chart B Distribution of the CET1 capital ratios of banks participating in the comprehensive assessment

(x-axis: percentile of the distribution, y-axis: CET1 capital as a percentage of risk-weighted assets)



Source: ECB.
Note: Distribution censored at 5th and 95th percentile to remove outliers.

3 See *Aggregate report on the comprehensive assessment*, ECB, October 2014.

a downward revaluation of trading assets and sovereign bonds, as well as from non-interest income. Overall, the capital ratio of the median bank would be reduced by around 4 percentage points, to about 8.3% (see Chart B).

Conclusions

The comprehensive assessment has caused euro area banks to take extensive action that has raised capital and reduced risk to mitigate potential capital shortfalls. In addition to capital measures taken prior to the end-2013 cut-off date of the comprehensive assessment exercise, banks continued to strengthen their balance sheets in 2014 (see Section 3.1 for more details). Twelve of the banks that were found to have a capital shortfall had already covered these shortfalls prior to the end of the exercise. The remaining 13 banks, with a combined capital shortfall of €9.5 billion, are implementing capital plans and are expected to reinforce their capital buffers. The capital actions should be completed within six months of the end of the assessment[4] if shortfalls result from the AQR or the baseline scenario, or within nine months in case of shortfalls resulting from the adverse scenario.

From a forward-looking perspective, the results of the comprehensive assessment represent a major step towards balance sheet repair and strengthening the euro area banking sector, which in turn is key to enable the sector to support the economic recovery in the euro area. The results have shown that the vast majority of significant euro area banks are able to withstand a major adverse macro-financial shock without breaching the 5.5% CET1 ratio threshold. The findings of the ECB's latest bank lending survey, which indicate that banks have begun to ease their lending standards, corroborate the conclusion reached in the comprehensive assessment that the importance of supply-side constraints in euro area credit markets has diminished.

4 These results include two banks which are implementing restructuring plans agreed with the European Commission, under which one bank would have a zero shortfall and one bank would have a small shortfall.