EUROPEAN CENTRAL BANK

EUROSYSTEM

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PRESS RELEASE

ECB PUBLISHES MANUAL FOR ASSET QUALITY REVIEW

- Manual contains methodology for ten specific work blocks in “Phase 2” (on-site inspection) of the asset quality review (AQR).
- Key work blocks include the review of processes, policies and accounting, credit file review and collateral value appraisal, and review of level 3 fair value assets (see Annex for a description of all ten work blocks).

The European Central Bank (ECB) has today published its manual on the methodology for Phase 2 of the AQR. The manual provides guidance for the national competent authorities (NCAs) and their third-party support on carrying out the exercise.

Phase 2 follows the portfolio selection (Phase 1) and will run until August 2014. The AQR process is due for completion in October when the results will be released together with the results of the stress test conducted in cooperation with the European Banking Authority.

The manual includes detailed guidance on:

- procedures for **validating data** and checking model inputs;
- how to value **material exposures** and **collateral** and determine **provisioning needs**;
- processes for **quality assurance** and **progress tracking** to ensure timely completion;
- when to use independent, **external valuations** for assets;
- the use of industry benchmarks to **assess market values**.

The AQR is a key component of the **comprehensive assessment**, which aims to enhance the transparency of the balance sheets of significant banks, trigger balance sheet repair where necessary, and rebuild investor confidence prior to the ECB taking over its supervisory tasks in November 2014.

Below are **some key statistics of Phase 2** for the 128 banks subject to the comprehensive assessment.

- Total amount of risk weighted assets (RWA) of the portfolios selected for the review: **€3.72 trillion**, equivalent to **58% of total RWA** across the banks
- Estimated number of **credit files** reviewed on average per bank: **1,250**

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Annex

Annex – AQR execution phase

	Working block	Description
1	**Processes, policies and accounting review**	Bank processes, policies and accounting practices have a key impact on the carrying values of assets in banks' balance sheets and so must be reviewed. The review will cover the key topics that influence accounting balance sheet valuations. Such key topics include whether a bank correctly applies the fair value hierarchy, accounting classifications (e.g. available for sale), provisioning approach, treatment of non-performing exposures and forbearance.
2	**Loan tape creation and data integrity validation**	The credit analysis will be based on a "loan tape" provided by the bank. This loan tape includes account information such as segment classification, status, and credit performance data. The data must be of sufficient quality to perform the required analysis.
3	**Sampling**	The portfolios reviewed exceed 50% of risk weighted assets for all banks subject to the comprehensive assessment. Given the volume of analysis involved, it is not possible to review all exposures in the selected portfolio. Samples will therefore be taken, whereby specifics (such as loan classification and provisioning) of a particular credit (i.e. loans, advances, commitments or other off-balance sheet exposure) will be looked at in detail. The samples chosen must be both large and representative enough to allow for a robust analysis. The size of the sample will depend on the homogeneity of the portfolio, the risk of the portfolio, the total number of debtors and the level of debtor concentration.
4	**Credit file review**	National competent authority (NCA) bank teams will verify that credit exposures have been correctly classified (e.g. placed in the correct regulatory segment, non-performing loan status, impairment status) and that, if a specific provision is required, it has been set at an appropriate level. The credit file review work

		block will also be used to identify cases where a loss event trigger has not been hit, but a loss is more likely than not. For these cases, the expected future loss will be measured for incorporation into the stress test. The credit file reviews will cover all loans, advances, financial leases and other off-balance sheet items, including specialised asset finance such as shipping and project finance.
5	**Collateral and real estate valuation**	A key factor in determining the appropriate carrying amounts is the valuation of collateral or on-balance sheet real estate. Generally, the majority of collateral will be revalued for all debtors selected in the sampling that do not have a third-party valuation less than one year old. This will be carried out by NCA bank teams and will feed into other blocks of the exercise.
6	**Projection of findings of the credit file review**	Findings of the credit file review will then be projected to the wider portfolio, with the aim of assessing the adequacy of provisions. Projection of findings will be applied to homogeneous exposure pools (in line with audit guidelines).
7	**Collective provision analysis**	Smaller, homogeneous, impaired exposures are typically provisioned using a collective provisioning approach – that is, a point-in-time statistical model of incurred loss. Similarly, general provisions are usually set using collective models for the whole portfolio. In order to verify that provisioning levels are appropriate, it is critical to ensure that collective provisioning models are fully aligned with the letter and spirit of accounting rules (International Accounting Standards (IAS) 39 or national generally accepted accounting principles).
8	**Level 3 fair value exposures review**	For banks with material level 3 exposures, a thorough revaluation of the most important exposures will be carried out on a selective basis – i.e. not all banks will be analysed. For banks with material level 3 banking book exposure, a revaluation of the most important securities will be carried out. For the banks with the most important trading books, a qualitative review of trading book core processes (independent

		price verification, product approval, etc.) will be carried out, combined with a quantitative review of the most important derivative pricing models (measured by metrics such as level 3 gross mark-to-market) from a level 3 perspective. It is expected that, in most cases, fewer than ten derivative pricing models will be reviewed for each bank included in the trading book review, depending on the size of the bank's exposure to level 3 derivatives. Some banks included in the trading book review will have no relevant level 3 derivative pricing models to review.
9	**Determine AQR-adjusted Core Equity Tier (CET) 1%**	Banks are only expected to change the 2013 certified accounts in the unlikely event that the AQR highlights issues that should lead to restatement according to local law, e.g. identification of accounting irregularities. Banks will be expected to reflect findings from the AQR in their accounts, where found necessary in the relevant accounting period in 2014 following the AQR. For example, banks may be expected to: - correct specific provisions for individually impaired credit facilities that were sampled in the file review; - correct specific provisions for collectively impaired credit facilities, where the bank's collective provisioning model is considered as missing crucial aspects required in accounting rules (in this case, banks would be expected to correct internal models and policies); - create a credit valuation adjustment for derivatives. Other findings from the AQR will not be included in 2014 accounts, as they do not explicitly comply with accounting rules (e.g. they do not relate to incurred losses). These include the extrapolation of findings from sampled files to the wider portfolio. Together with the stress test findings, such AQR findings will form the basis for supervisory measures requiring banks to cover potential capital shortfalls. In order to correctly account for all additional incurred losses identified within the previous work blocks, an "AQR-adjusted CET1 ratio" will be calculated for each bank. This AQR-adjusted CET1 ratio (which is calculated according to the single rule book of 1 January 2014) will be used to compute the final stress test outcomes.

		Banks will neither be required to restate accounts nor to apply the AQR assumptions on an ongoing basis. The AQR-adjusted CET1% is not a de-facto alternative accounting standard.
10	**Quality assurance**	The NCA bank teams are responsible for all results delivered to the ECB and should apply a four-eyes principle to ensure the quality of the exercise at the national level. This quality assurance at the national level will not be led by the ECB, which will focus on ensuring cross-system consistency and a level playing field across systems on completion of the comprehensive assessment.

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