BANK NEWS

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SPECIAL ISSUE : ECB STRESS TEST RESULTS

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EDITORIAL

On 26 October, after an unprecedented exercise which has involved thousands of people over a period of nearly a year within almost 130 banks and banking supervisors, the ECB published the results of its comprehensive assessment of systemic financial institutions. This publication, which comes just before the Single Supervisory Mechanism (SSM) takes on the supervision of credit institutions, has been the subject of many comments and much debate, in particular as to the adequacy of the stress parameters used. But beyond this debate, the exercise and its consequences shed a fresh light on the challenges that await both banks and regulators and supervisors.

This edition presents our analysis of the results of the comprehensive assessment, but more importantly it sets out our vision of the challenges that the current changes in banking regulation and supervision will bring in the euro area. Challenges which could soon be extended to insurance companies if, like the Central Bank of Romania which has just launched a balance sheet assessment and stress test exercise, EIOPA decides to apply this approach systematically.

MAZARS

THE BANKING INDUSTRY TRACKER

PERFORMANCE OF THE MAIN EUROPEAN BANKING GROUPS IN 2014

As of 30.06.14 in M€	Total Assets		Operating Income		Risk-Weighted Assets		Credit risk		Cost-income ratio		Core Tier 1	
HSBC	2010.9 ↑	3%	22.9 ↓	-9%	912.1 ↑	3%	1.4 ↓	-41%	59% ↓	-5%	11% ↑	4%
BNPP	1906.6 ↑	6%	19.5 ↑	2%	625.0 →	0%	1.9 ↑	4%	66% ↑	3%	10% ↓	-3%
Deutsche Bank	1665.0 ↑	3%	16.3 ↓	-8%	398.7 ↑	14%	0.5 ↓	-40%	81% ↑	5%	15% ↑	15%
Crédit Agricole	1518.1 →	0%	7.9 ↑	1%	291.3 ↓	-3%	1.1 ↓	-20%	69% ↓	-2%	10% ↑	16%
Barclays	1642.6 →	0%	16.5 ↓	-12%	513.4 ↓	-7%	1.3 ↓	-33%	73% ↓	-6%	10% ↑	9%
Société Générale	1322.6 ↑	9%	11.6 ↑	4%	350.7 ↑	2%	1.4 ↓	-26%	66% →	1%	10% ↓	-10%
RBS	1263.1 ↓	-2%	12.3 ↓	-6%	489.8 ↓	-9%	0.3 ↓	-87%	64% →	0%	10% ↑	17%
Santander	1188.0 ↑	5%	20.6 ↓	-4%	558.9 ↑	14%	5.3 ↓	-18%	47% →	1%	11% ↓	-7%
BPCE	1151.9 ↑	3%	11.9 ↑	4%	404.0 ↓	-1%	0.9 ↓	-9%	69% ↓	-2%	11% ↑	7%
Moyenne	1120.3 ↑	2%	12.5 ↓	-4%	375.9 →	0%	1.2 ↓	-32%	64% →	1%	12% ↑	2%
Lloyds TSB	1054.2 →	0%	11.4 ↓	-2%	320.8 ↓	-6%	0.9 ↓	-58%	51% ↓	-4%	11% ↑	8%
ING	970.5 ↓	-10%	15.4 ↑	12%	293.3 ↑	4%	0.9 ↓	-26%	56% ↑	3%	11% ↑	5%
Unicredit	838.7 ↑	1%	11.3 ↓	-5%	398.7 ↓	-6%	1.8 ↓	-32%	61% ↑	3%	11% ↑	10%
UBS	809.1 ↓	-3%	11.8 ↓	-5%	186.7 →	1%	0.0 ↓	-178%	82% ↓	-2%	14% ↑	5%
Crédit Suisse	734.2 ↑	2%	10.9 ↓	-5%	235.0 ↑	4%	0.0 ↓	-29%	71% ↑	3%	14% ↓	-12%
Nordea	636.7 ↑	1%	5.0 →	-1%	152.2 ↓	-27%	0.3 ↓	-24%	49% ↓	-4%	15% ↑	2%
BBVA	617.1 ↑	3%	10.4 ↓	-5%	336.6 ↑	4%	2.2 ↓	-19%	51% →	-1%	12% →	0%
Commerzbank	582.6 ↑	6%	6.5 ↓	-12%	217.0 ↑	14%	0.5 ↓	-38%	76% ↑	6%	12% ↓	-11%
KBC	252.8 ↑	6%	3.1 ↓	-21%	82.3 ↓	-9%	0.2 ↓	-56%	63% ↑	21%	13% →	1%

MAZARS INSIGHT

ECB STRESS TEST : A USEFUL CHECK-UP OF THE EUROZONE'S BANKS

BY GREGORY MARCHAT - HEAD OF BANKING CONSULTING AT MAZARS UK

The ECB announced on October 26 the results of its stress testing exercise, the final stage in the Comprehensive Assessment of the Eurozone's Systematically Important Financial Institutions (SIFIs).

The final report found that under an adverse scenario, a €24.19 billion capital shortfall would arise in 2016 across 24 banks. Since EU banks have already raised additional capital in 2014, the current gap would be €9.52 billion. The capital shortfall is decreased further (to €6.4 billion), after excluding the restructuring plans of Greek banks and the shortfalls of the Belgian Dexia and two Slovenian banks. Half of the residual shortfall (€3.3billion) is found in four Italian banks, with Monte Dei Paschi showing the biggest potential for losses (€2.1billion).

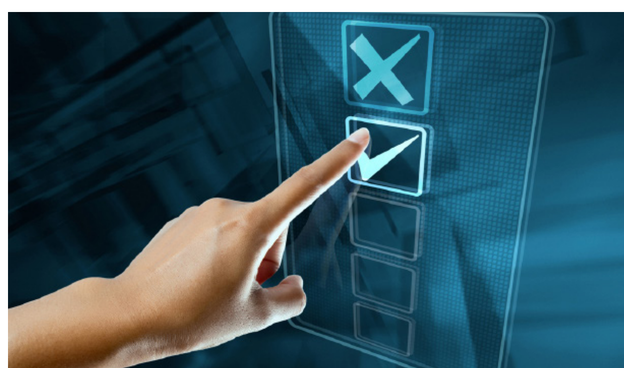
Overall, the findings of the stress test were in line with expectations: the banks that failed had low Common Equity Tier 1 (CET1) levels before the exercise and Italy's banks suffered the heaviest hit. Banks that underperformed had two weeks after the unveiling of the results to submit new capital plans explaining how they plan to cover capital shortfalls in the next six to nine months.

Unlike the two exercises conducted by the EBA in 2010 and 2011, this assessment sought to give a fair and credible representation of banks' losses from the recent crisis. Its main goal was to restore investor confidence in the European banking sector. Once the credibility of banks' balance sheets is re-established, it is hoped that credit expansion will resume in the euro-area, paving the way for sustained economic recovery. The effectiveness of the stress tests in achieving this goal is still to be seen.

MANAGING THE NEW REGULATORY LANDSCAPE

Following the exercise, banks will have to manage multiple relationships within the new regulatory architecture consisting of national and European supervisory bodies. For example, banks will be requested to provide more information to national competent authorities (NCAs) and European regulators to ensure adequate prudential supervision.

Part of this new landscape will be the ECB's Single Supervisory Mechanism (SSM), which took over the supervision of major banks on 4 November 2014. This is important because the SSM is one of the three major components of the proposed banking union. Together with the completion of a single rulebook for all financial institutions and a single resolution regime across the Euro-zone, the SSM aims to restore financial stability and better integrate the banking system in the Euro-area.



FUTURE STEPS

The ECB's stress tests highlighted the fact that NPL management is essential for all banks. In addition to requiring that banks' NPL portfolios comply with accounting standards, the ECB has added a second layer of methodology with direct impact on capital adequacy. While countries like Ireland, Italy and Spain have already gone through several rounds of AQRs/stress tests and reviews of NPL management, there is a large number of countries that will need a real adjustment: Greece, Cyprus and most of Eastern Europe. Every bank will need to have a dedicated team specialising in distressed operations.

More assessments are also to be expected. It is likely that NCAs will have to launch their own stress tests to assess non-SIFIs, whose combined size is estimated to be the same as the whole of the US banking system. Given their size and the fact that these non-SIFIs are less sophisticated, mostly retail banks, an adverse scenario could potentially have a significant impact.

This new structure of centralised supervision will also mean a more homogenous approach to overseeing banking activities and practices. The ECB and EBA will issue a series of Regulatory Technical Standards (RTS) in order to provide the NCAs with the same tools to supervise their financial institutions. The first RTS paper is already in the consultation phase and concerns "the specification of the assessment methodology for competent authorities regarding compliance of an institution with the requirements to use the IRB Approach in accordance with Articles 144 (2), 173 (3) and 180 (3) (b) of Regulation (EU) No 575/2013".

THE ECB STRESS TESTS HIGHLIGHTED THE FACT THAT NPL MANAGEMENT IS ESSENTIAL FOR ALL BANKS

Following the ECB/EBA's example, it is also very likely that EIOPA and ESMA will want to demonstrate that they have the same scope in their areas of supervision. We can already see signs of their new approach to stress-testing:

- a stress test and balance sheet review of the insurance sector have been launched in Romania; and
- he next big exercise will assess how Central Counter Parties (CCPs)can sustain a severe shock, as the SIFI definition has been extended to include them.

This is a series of anticipated developments arising from the creation of the SSM and the increase in central supervision from European Supervisory Authorities. While it is clear that the level of control from these institutions will continue to increase, we can only guess the depth of their reviews.

The regulatory landscape is clearly not completely stabilised yet; financial institutions should be prepared to further develop their capacity to anticipate, understand and integrate the future flow of requests for information and specific prudential rules.

ANALYSIS

Jean-Baptiste BELLON
Trapeza Conseil

Trapeza is an independent consultancy and research firm specialising in the banking sector. Trapeza's role is to advise and assist banking professionals and investors on performance measurement. The analysis draws on several tools used on the financial markets, and brings together accounting, financial and strategic data.

AQR AND STRESS TESTS

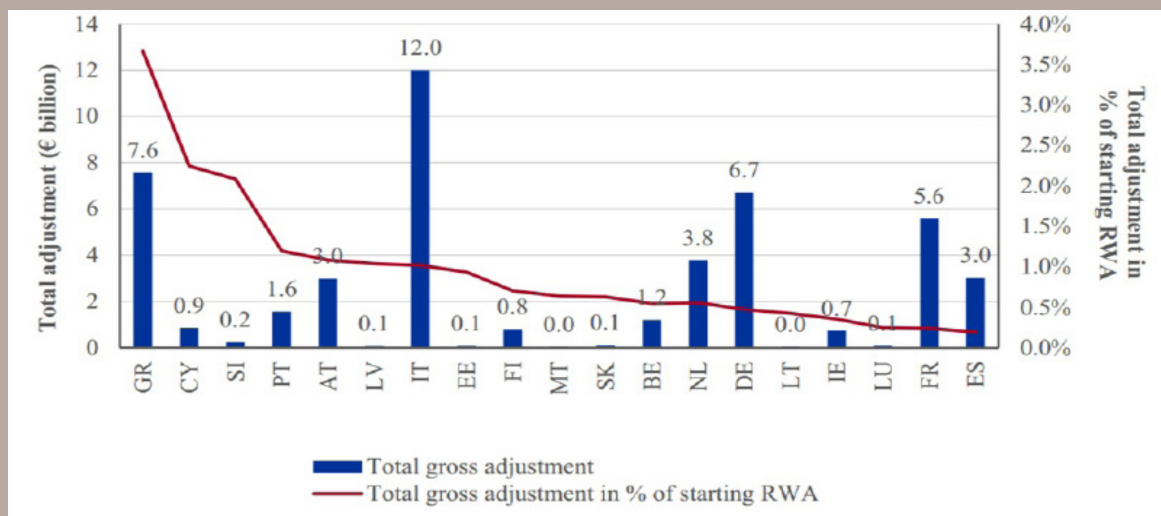
BY TRAPEZA CONSEIL

Investors seem to have been slightly disappointed by the publication of results of the Asset Quality Review and stress tests. Perhaps this is a good sign, since the preceding tests were instead initially welcomed by the markets*. However, measuring the effectiveness of the exercise by investors' reactions has obvious limits, as their expectations had been partly framed on the one hand by the ECB and the EBA and on the other by bank management.

At a time of sluggish growth, the AQR constitutes a more important exercise than stress tests, which aim to send a generally reassuring message to bank customers and depositors. They confirm that **the solvency of European banks is improving and continues to be monitored**. The total impact of the AQR on the 130 banks analysed is only 0.4% of the Common Equity Tier 1 ratio, which brings the overall ratio from 11.5% to 11.1%, but this impact is high in the peripheral countries such as Greece, Cyprus or Slovenia (more than 2% of the ratio), while it is very limited in Spain and in France (less than 0.2% of the ratio).

* The publication of stress tests results by the CEBS in July 2010 and the EBA in July 2011 had on both occasions a very positive impact on European banking indices. In 2010 the impact was +5% over the five days following publication in both absolute and relative terms (the market index was stable). This variation rises to +10% if we include the evolutions that took place in the five days preceding the tests. In 2011 the rise was only significant after the test results were published, with +6% in absolute terms and +4% in relative terms during the five following days. For banks in the euro area the effect is more marked, with a relative rise of 7% over this period.

GROSS AQR ADJUSTEMENT BY COUNTRY OF PARTICIPATING BANKS

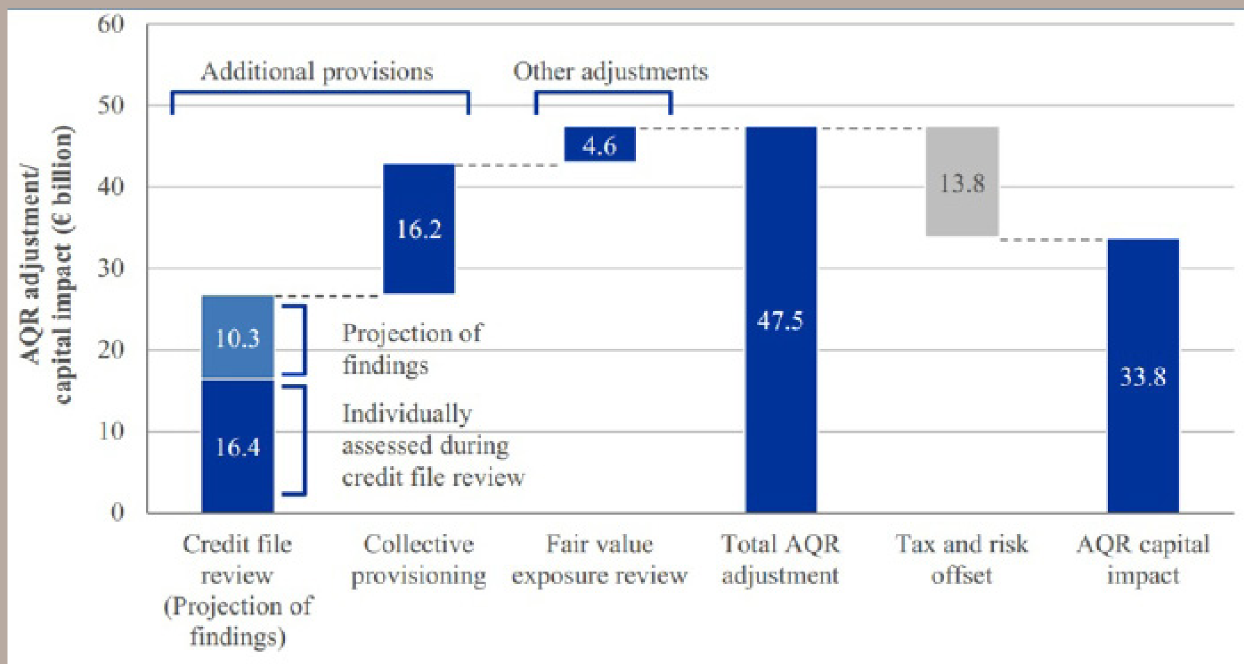


Source : ECB

In terms of individual banks, the AQR entails very considerable adjustments in Italy for MPS (€4.2 bn), Popolare (€1.5 bn) and the two large groups Unicredit and Intesa (a little less than €1 bn each), and in Greece (Piraeus: €2.7 bn, NBG: € 2.2 bn and Eurobank €1.2 bn).

The ECB's AQR adjustments amount to €10.1 bn and derive from the still-imperfect implementation of common standards for the definition of non-performing loans and provisioning methods. Overall, the asset quality review brought to light €136 bn 'new' nonperforming loans, from commercial property-related and large corporate exposures and exposures to 'large' SMEs. This 15% rise in NPLs as compared with the published figures has increased the provisioning required by €48 bn, with a reduction of €34 bn of core capital. These adjustments to 2013 year-end balances were partly applied in the accounts for the first half 2014, but the total impact will be seen in the 2014 published accounts of many banks.

IMPACT OF THE AQR ON CAPITAL



Source : ECB

Stress tests used a combination of a baseline scenario and an adverse scenario in which GDP shrank by an aggregate 6.6 points over the period, a level comparable to that applied in American tests. While the desire to create a test framework close to that of the FED is fairly obvious, it is not certain at this stage that the quality is the same. But progress since the previous tests has been marked, with the application of a common methodology covering a wider range of risks. The aim is to reassure the markets of the banks' capacity to cope with a crisis, but not to take account of market (asset) values in order to assess the resilience of the banks.

Of the 123 banks tested, 24 failed to reach the CET1 target of 5.5% in 2016 in the adverse scenario. This is a high number, but low in terms of recapitalisation with a shortfall of €25 billion, since these were mainly small or medium-sized institutions.

The tests were failed by banks already identified as vulnerable, those where a restructuring plan was in progress (Greece and Cyprus), or groups already marked for extinction (Dexia, Volksbank in Austria). The tests used old data and 2013 balance sheets, and some banks identified as failing have have already raised additional capital in anticipation (CRH for example) and the real recapitalisation required will probably not exceed €5-6 bn.

But the exercise clearly identifies Italy as the country where strengthening solvency must be a priority, with nine average or small institutions appearing in the list of 24 banks. The inclusion of significant Italian banks, such as MPS, Carige, BP Milan and Popolare but not the two major groups, only lends weight to this observation.

BANKS FAILING THE EBA'S STRESS TESTS

	Banks	Country	Restructuring plan	AQR	ST transitional method baseline	ST transitional method adverse
				< 8%	< 8%	<5,5%
1	Cooperative Bank	Cyprus	yes	-3.7%	0.5%	-8.0%
2	Carige	Italy		3.9%	2.3%	-2.4%
3	Hellenic Bank	Cyprus		5.2%	9.1%	-0.5%
4	Veneto Banca	0		5.7%	5.9%	2.7%
5	CRH	France		5.7%	5.7%	5.5%
6	Munchener Hypo	Greece		6.9%	5.8%	2.9%
7	BP Milano	Italy		6.9%	6.9%	4.0%
8	MPS	Italy	yes	7.0%	6.4%	-0.1%
9	BP Sondrio	Italy		7.4%	7.4%	4.2%
10	NBG	Austria	yes	7.5%	5.7%	-0.4%
11	Credito Valtellinese	Italy		7.5%	7.1%	3.5%
12	BP Vincenza	Italy		7.6%	7.7%	3.2%
13	Eurobank	Austria	yes	7.8%	2.0%	-6.4%
14	Banca Popolare	Italy		7.9%	6.7%	4.7%
1	Volksbank	0	yes	10.3%	7.2%	2.1%
1	Permanent TSB	0		12.8%	8.8%	1.0%
2	Bank of Cyprus	Cyprus	yes	7.3%	12.9%	1.5%
3	BCP	Portugal	yes	10.3%	8.8%	3.0%
4	AXA Banque Europe	Belgium		14.7%	12.7%	3.4%
5	Piraeus	Austria	yes	10.0%	9.0%	4.4%
6	NKB Maribor	Slovenia	yes	15.7%	12.8%	4.4%
7	Dexia	Belgium	yes	15.8%	10.8%	5.0%
8	NLB	Slovenia	yes	14.6%	12.8%	5.0%
9	BPER	Italy		8.4%	8.3%	5.2%

Source : EBA

BANKS WHICH WOULD HAVE FAILED STRICTER TESTS

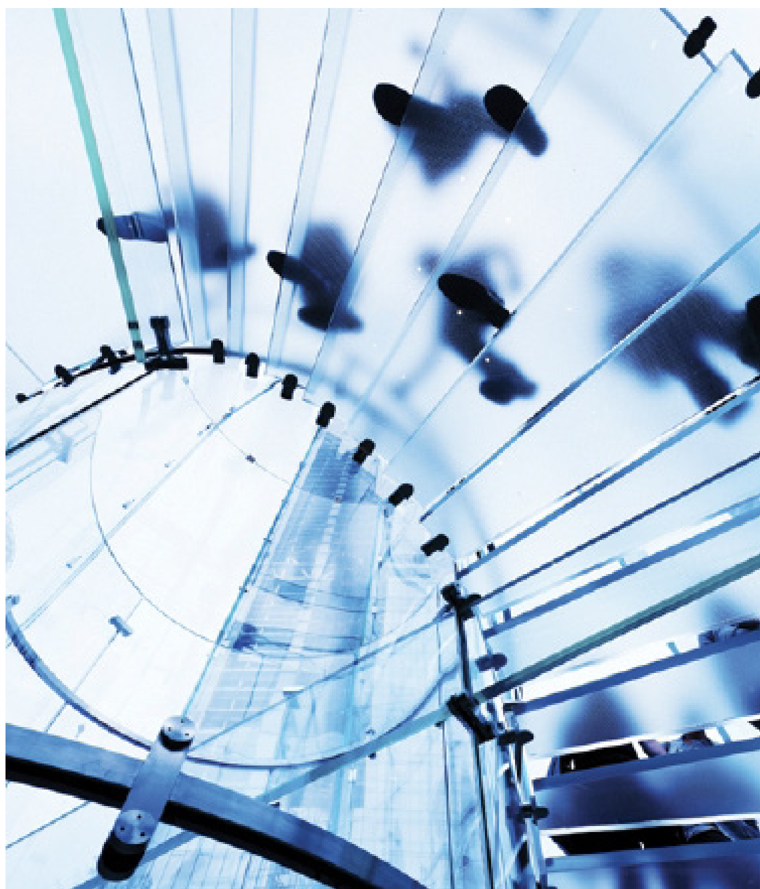
	Banks	Country	Restructuring plan	AQR	ST definitive method baseline	ST definitive method adverse
1	AIB	Ireland	yes	14.6%	1.7%	-3.6%
2	RZB	Austria		9.7%	5.6%	3.9%
3	WGZ	Austria		10.0%	6.9%	4.8%
4	Liberbank	0	yes	7.8%	7.0%	2.9%
5	BAWAG	Austria		14.3%	7.5%	4.5%
6	DZ Bank	Germany		9.0%	7.8%	4.9%
7	Bank of Ireland	Ireland	yes	11.8%	7.9%	2.9%
1	Alpha Bank	Greece	yes	14.0%	9.0%	1.3%
2	HSH Nordbank	Germany	yes	10.0%	8.3%	4.8%
3	CGD	Belgium	yes	10.4%	8.4%	4.9%
4	SNS Bank	Netherlands	yes	14.9%	15.0%	4.9%
5	LBW	0	yes	13.5%	11.1%	5.5%

Source : EBA

The transparency of the tests has been significantly increased by **the publication of the results on the basis of definitive Basel III CET1 ratios.** According to these criteria, 12 additional institutions would fail to meet the thresholds of 8% (baseline scenario) and 5.5% (adverse scenario).

This includes the two main Irish banks, but these are benefiting from markedly improved economic developments after a severe recession, accompanied by property prices which are recovering after a fall of over 40%. The German and Austrian institutions in this list are not negligible, since they are major cooperative and important public regional banks (Landesbanken).

Finally, if this definitive method were used a dozen banks would have 2016 CET1 ratios under the adverse scenarios that would be close to the minimum of 5.5%, including the two British banks undergoing restructuring, RBS (5.7%) and Lloyds BG (6%).



However if the stress tests seem to model the impacts of a severe shock, with CET1 ratios declining by 4.1% (from 11.1% at 7% on average), the capacity of external observers to understand the relevance and the scope of the exercise remains limited, as in the previous tests.
Interpretation is complicated by:

- The discrepancies between the published accounts and the prudential consolidation scope to which the tests refer are not explained.

- The detail of 2013 earnings, the starting point for the scenarios, does not correspond to the banks' published figures, in terms either of trading revenues, commission or other revenues, because of reclassifications carried out. This is also attributable to the failure to publish the amount of operating costs which can be calculated as the difference between revenues and the GOI.

- Nor do the figures for credit provisions in the 2013 published accounts correspond to the basis used for 2013 in the tests.

- The data used for profit distribution often seem rather remote from the information published in the banks' financial information.

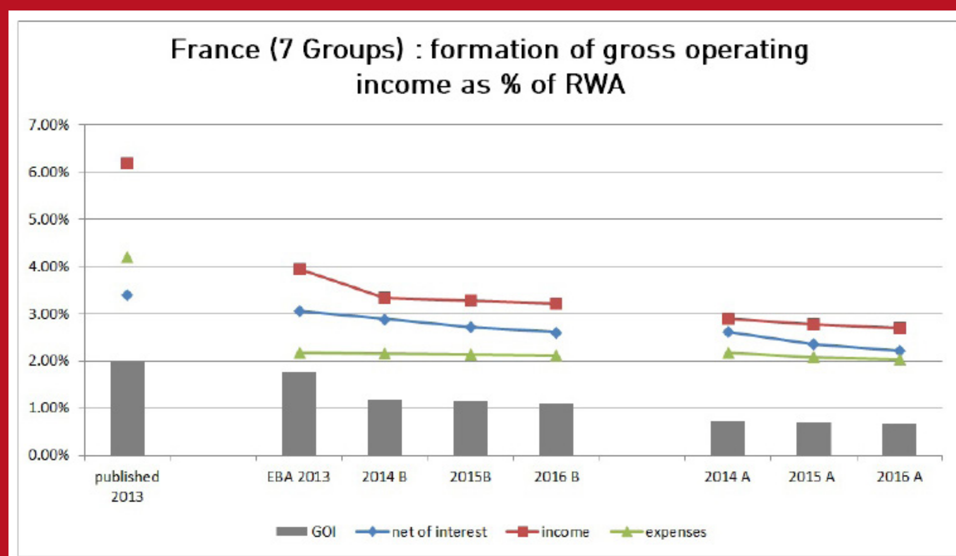
- The amounts of coupons on hybrid debt which appear wholly or partly in equity under IFRSs – an anomaly often highlighted by accounts users – are not explicitly reintegrated into the income statement.

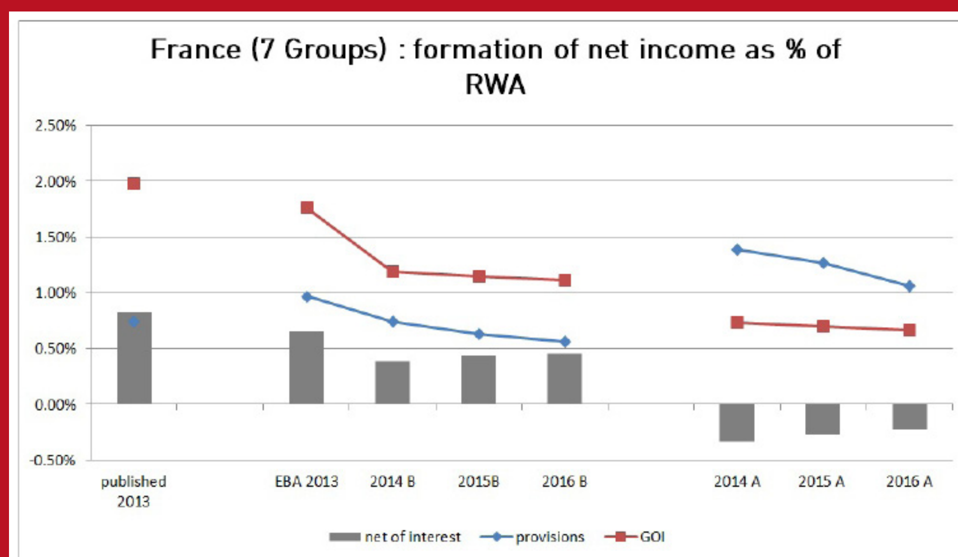
- The contributions of activities outside the prudential scope, for example insurance, are not itemised.

- And finally, the impact of activities outside Europe is not isolated, which damages the ability to comprehend the impact of the adverse scenario.

An analysis of the stress data for the group of seven large French banks included tends to suggest that the baseline scenario is probably too pessimistic, while the adverse scenario is perhaps not pessimistic enough. In the baseline scenario, the risk weighted assets (RWA) hardly change over the period 2013-2016 (+4%) but increase a little more in the adverse scenario (+11%).

EBA TESTS : RESULTS FOR THE GROUP OF 7 FRENCH BANKS





Note : the seven groups are BNPP, BPCE, CA, Crédit Mutuel, HSBC France, LBP and SG.
Source: EBA and Trapeza Conseil calculations.

The gap between the two scenarios in 2016 is in the order of 0.7 points on RWA, an order of magnitude close to that of the 2011 stress test. Most of this gap comes from provisions, in particular credit provisions, which are 0.5% in the baseline scenario and 1% in the adverse case.

In conclusion, while the transparency of the tests has increased, they nevertheless remain in need of improvement, particular when compared with the tests used by the US FED. The introduction of supervision of large banks in the euro area by the ECB in November 2014, the creation of ex ante guarantee funds and resolution mechanisms in Europe in 2016* will form the background to the next round of tests, and the 2014 tests mark the start of the inclusion of credible tests in the banks' management tools.

* Or in 2015 in some countries, such as the UK or Austria.

Olivier Perquel is Head of Financing and Market Solutions at Natixis, where he has been a member of the Executive Board since May 2011.
He was previously Head of Strategy and Ring-Fenced Asset Management (GAPC), the bank's default division. After beginning his career in mergers and acquisitions at Lazards, Goldman Sachs and Merrill Lynch, he went on to work in alternative asset management at a number of investment funds before being appointed to his current post by Laurent Mignon, the new CEO of Natixis, in May 2009.
At Natixis, he has held several positions, including Head of the GAPC division, where he reduced the bank's risk-weighted assets by €9 billion, restructured Coface and steered its recent IPO.

OLIVIER PERQUEL

HEAD OF FINANCING AND MARKET SOLUTIONS AT NATIXIS

In the light of the Asset Quality Review results, credit institutions could once more have recourse to hive-off vehicles enabling them to reduce their outstanding strategic exposures whether or not at risk. Drawing on his experience at the head of the Natixis hive-off structure, Olivier Perquel discusses the changes under way and their impact on hiving-off and internal separation.

WHAT DO YOU THINK ABOUT THE GROWTH IN RING-FENCING STRUCTURES ?

OLIVIER PERQUEL : in the wake of the institutional bad banks (CDR, Crédit Foncier, Dexia) and their rescue by the state, we have gradually moved on to internal structures for liquidation management. These entities come in all shapes and sizes and may or may not involve changes to the legal structure of the institutions concerned. At Natixis, we did not modify our structure but we created a specific division for the active management of ring-fenced portfolios (GAPC). The main aim was to remove the relevant assets from the balance sheet as quickly as possible.
The vital ingredient is the organisation and governance of these entities. This means bringing in external partners to manage the division's activities. The sole focus of these teams is to find the best way of liquidating the assets. In this respect, it is vital to build a "Chinese wall" to separate these assets from the bank's other activities, without worrying about the upside of the assets that have been ring-fenced. What matters is their economic value, their market value.

HOW LONG DOES IT TAKES ON AVERAGE TO DISENGAGE FROM THESE KINDS OF ASSETS WHILE STILL CREATING APPROPRIATE VALUE?

OLIVIER PERQUEL : it is important to act fast. If we take the example of the GAPC, just one year after its creation in summer 2009 we had already significantly reduced the risk profile by transferring most of the portfolio of complex derivatives.

WHAT ARE THE KEY CRITERIA FOR CLASSIFYING ASSETS AS «NON-CORE»?

OLIVIER PERQUEL : it all depends on the institution's strategy, including in terms of regulatory constraints and synergies with other activities. After completing our review of risk-weighted assets (RWA), we concentrated on assets that were risky or too risky for our strategy at Natixis.

This led us to decide to withdraw from maritime financing, private equity [sold to Axa], and so on. As for Coface [recently listed on the stock exchange], this was clearly an asset that had no particular synergies with the rest of our activities. Once again, the key is to be efficient by obtaining tangible results as quickly as possible.

The main thing is to set goals and stick to them. This is the best way to show that you are really in control. It is all a question of governance and execution.

IS THE CREATION OF NEW DEFEASANCE STRUCTURES A SOLUTION IN LIGHT OF THE INCREASE IN PRUDENTIAL OVERSIGHT REQUIREMENTS?

OLIVIER PERQUEL : with the Asset Quality Review (AQR) and stress tests that are taking place at a European level, there will inevitably be some surprises, particularly among medium-sized institutions in Germany and Spain. As a result, some banks will have no choice but to gain backing, recapitalise or reduce their risks by ring-fencing certain assets in order to deleverage them. When viewed from this angle, defeasance is a good idea.

"SOME BANKS WILL HAVE NO CHOICE BUT TO GAIN BACKING, RECAPITALISE OR REDUCE THEIR RISKS."

It stands at the crossroads of strategy and regulation for the institutions concerned. Managing a closure is a complicated exercise. It requires strong consensus and real involvement on the part of the management. It is always difficult to think in terms of economic value and market position rather than in terms of book value or P&L. This type of management is inevitably quite restrictive, particularly because it is a case of making decisions on the transfer price.

Read mazars thought leadership on the 'New Forms of Defeasance Structures' here

A GOOD BANK REQUIRES GOOD SUPERVISION : A CHALLENGE FOR THE ECB

BY EMMANUEL DOOSEMAN, DEPUTY HEAD OF BANKING AT MAZARS

As November saw the official launch of the Single Supervisory Mechanism (SSM), which will in future ensure the supervision of all the banks in the euro area, it seemed appropriate to consider briefly the key issues and challenges of a supervisory mechanism, not least the restoration of economic actors' confidence in the banking and finance system. In order for the banks to play their role in our economies as the transmitters of financial flows to the full: collecting surplus financial resources (short or long), financing deficits or investment needs, they must enjoy the trust of all the stakeholders, all the other economic players.

SUPERVISION PLAYS A CRUCIAL ROLE IN ESTABLISHING A RELATIONSHIP OF TRUST BETWEEN BANKS AND THE OTHER ECONOMIC PLAYERS.

To this end, the banks are evolving in an environment which is tightly regulated, whether by laws, regulations or directives. In other words banking operates under the constraints of regulation, which determines the rules of the game. But a supervisory mechanism, the natural companion of regulation, may - depending on the degree of freedom available within the initial regulation - play a greater or lesser role in defining these constraints and the achievement of a conditioned optimum. Thus supervision plays a crucial role in establishing a relationship of trust between banks and the other economic players.

A supervisory system that brings together all the measures taken to monitor the operation of banks and the banking system; that reports on normal or abnormal operations, and ensures respect for the constraints imposed by the rules.

Banking supervision allows the identification of malfunctions in the system and in the banks themselves. It reports on the existence of deviations from the rules, alerting economic players, public authorities and supranational organisations. These supervisory measures are a source of information which is vital in developing a relationship of trust between banking and its environment. In this sense, the results of the controls carried out by the supervisors are tools for measuring compliance and the confidence that can be placed in a bank.

However, in order to be effective, the quality of the information supplied by the supervisor must be understood by economic players. This information must also be measurable, for the purposes of comparison. In order to be measured, it should first be calibrated and its relevance to the needs of economic agents must be ensured.

Now the banking supervisor is often faced with a problem in exercising its controls and their restitutions.

In most settings, the supervisor or more generally the supervision mechanism draws on a body of rules. This delivers information emerging from the controls: clear, without grey areas, without ambiguities, without interpretation. The rule is straightforward, it applies to everyone in the same egalitarian way, and it is generally understood by all. Hence the results of the controls, of the supervision itself, are factual and objective. A standardised approach based on the rules allows comparability with no risk of distortion. Either a rule is respected or it is not. The approach is binary, Manichaean. It is easy to implement and easy to understand. Furthermore, its relative simplicity means that it is generally not too costly to deploy.

In a rule-based approach, the question is whether these rules are properly defined, relevant and effective in terms of the risks, the capacity for financial innovation and the practices of the banks. In this approach, the supervisor merely carries out directions. The regulator is the key player, who guides and sets the controls and delegates their implementation. The supervisor is not empowered to assess the situation, to adapt its controls or alter its warnings. This can lead to a degree of inflexibility, or even a lack of relevance where the environment is evolving rapidly, or where there is intensive technical innovation without challenge to the regulatory framework.

But the work of the banking supervisor is more complex, more involving. The conclusions of its supervisory work are less binary. In many aspects of its work, it is in charge of verifying respect for the principles. This means that it must take up a position, interpret, evaluate. In order to successfully perform its remit, the banking supervisor must take account of the specific profile of each of the banks in the system and adapt its monitoring and controls. The approach is on an individual basis, adapted to suit risk and organisational profiles. The supervisor takes account of various aspects, assesses and compares them, creates a benchmark and assesses the results of supervised banks before reaching a judgment on compliance with the regulations.

THE BANKING SUPERVISOR MUST TAKE ACCOUNT OF THE SPECIFIC PROFILE OF EACH OF THE BANKS IN THE SYSTEM AND ADAPT ITS MONITORING AND CONTROLS.

This process makes the comparison between institutions more complex. The supervisor's scope for interpretation is greater, and a degree of subjectivity can enter the equation. The freedom that the supervisor enjoys when verifying the proper application of a principle rather than a rule is such that it may at times become a player in regulation, establishing rules for interpretation of principles or doctrine. We may then wonder about the changes a supervisory authority brings to the the system, but equally we can question the blurring of the roles of supervisor and regulator.

Furthermore, the reading of the results by economic players is also more complex; they have to calibrate results and analyse the information provided by these controls in a comparative manner. This can lead different economic players to reach divergent views of the same result. This is a very different situation to that which applies when a rule-based approach is taken. Everyone can take ownership of the result and judge it. This was illustrated very recently by the comments made when the "Comprehensive Assessment" was published, despite the fact that very precise guidance to the controls had been issued by the ECB, and that doctrines had sometimes been replaced by principles to facilitate the analysis of bank balance sheets.

IT IS ON THIS APPROACH – BASED ON PRINCIPLES, RISK ANALYSIS AND THE USE OF JUDGMENT – THAT THE SSM WILL RELY ON TO FULFIL ITS TASKS, NOT LEAST IN RESTORING AND MAINTAINING TRUST IN THE BANKING SYSTEM OF THE EURO ZONE.

However, it is on this approach – based on principles, risk analysis and the use of judgment – that the SSM will rely to fulfil its tasks, not least in restoring and maintaining trust in the banking system of the euro zone. These aspects were confirmed in the guide to banking supervision published by the ECB in September 2014.

The SSM will therefore face a great challenge when it exercises supervision on the basis of principles and communicates the most uniform and comparable results possible. The creation of a body of interpretations of these principles which is precise enough to enable comparisons between banks with as little subjectivity as possible, but flexible enough to take account of different business models, without in any way usurping the role of the regulator are crucial challenges. Furthermore, going beyond the supervision of banks, the SSM may also undertake educational outreach among economic players, training them to analyse the results in order to facilitate interpretation and contextualisation, particularly with regard to players outside the euro area.

MAZARS INSIGHT

THE TRANSPOSITION OF THE CAPITAL REQUIREMENTS DIRECTIVE IV AND THE CAPITAL REQUIREMENTS REGULATION IN IRELAND

BY MARK KENNEDY, PARTNER AT MAZARS IRELAND

IRELAND IS AMONGST THE FIRST WAVE OF MEMBER STATES TO COMPLETE THE TRANSPOSITION OF THE CAPITAL REQUIREMENTS DIRECTIVE IV (CRD IV) AND THE CAPITAL REQUIREMENTS REGULATION (CRR) INTO NATIONAL LAW.

Ireland is amongst the first wave of Member States to complete the transposition of the Capital Requirements Directive IV (CRD IV) and the Capital Requirements Regulation (CRR) into national law, which occurred on 31 March 2014. These two pieces of legislation represent the biggest change to capital requirements for financial institutions in the EU since the financial crisis. Credit Institutions have been considering the implications of Basel III for some time but this is new for Investment Firms (MiFID firms). The Central Bank of Ireland are responsible for ensuring firms comply with the new capital requirements and have implemented appropriate prudential reporting requirements. The following article is a brief introduction to the background and nature of this highly complex legislation.

BACKGROUND

The Basel Accord framework outlines standards for establishing minimum capital requirements, primarily for banks, and was prepared by the Basel Committee on Banking Supervisions (BCBS). CRD IV and CRR implement Basel III in Europe by introducing new liquidity requirements, remuneration provisions and capital requirements. The legislation also introduces new concepts such as capital buffers whilst also placing a regulatory framework on securitisations, derivatives trading and remuneration policies for the first time. The Capital Requirements Package aims to strengthen the resilience of credit institutions across the EU.

The Directive has 165 Articles and the Regulation has 521 Articles and both are highly complex. This article aims to outline the architecture of the new framework and to draw attention to issues likely to be relevant to the Board of Directors of a credit institution or investment firm. From 01.01.15 as part of the updated Corporate Governance Code, Directors' responsibilities include Capital and Liquidity reporting from the point of view of the Central Bank of Ireland (CBI). CRD IV and CRR contain a number of discretions for Member States in relation to national implementation, which may therefore lead to differences across Member States.

APPLICATION DATE

The regulation is applicable for both credit institutions and investment firms (MiFID firms) which deal as principal in securities or derivatives since 1 January 2014. As outlined in further detail below, other investment firms are subject to elements of the regime.

CAPITAL REQUIREMENTS

The Basel capital framework is built upon three pillars as follows:

Pillar I	Pillar II	Pillar III
Minimum Capital Requirements	*Supervisory Review Process*	*Market Discipline*
Enhanced Minimum Capital & Liquidity Requirements	Enhanced Supervisory Review Process for firm-wide risk management and capital planning	Enhanced Risk Disclosure and Market Discipline

Pillar I

The minimum capital requirement under Pillar 1 is the minimum capital a financial institution must hold in order to comply with CRR. Capital in this case means a cushion of cash, reserves and equity available to the financial institution in times of financial stress. The core requirement of Pillar 1 is that at all times the financial institution must maintain the following capital equation (at a high level):

{Regulatory Capital > 8% of Risk Weighted Assets* (RWA) plus Capital Buffers**}

Regulatory capital at a minimum must always be greater than 8% of RWA (there are also additional capital buffer requirements as outlined below). Regulatory Capital is made up of financial resources which can be split into layers or tiers, Tier 1 (higher quality) and Tier 2 (lower quality) and consists of equity or equity like instruments (eg: subordinated debt, hybrid instruments). Tier 1 can be further divided into Common Equity Tier 1 (CET 1) and Additional Tier 1 (AT1). Deductions must be made from financial resources which include goodwill, other intangibles, deferred tax assets, cash flow hedging reserve, securitisation gains on sale, fair value gains/losses due to changes in own credit risk, treasury stock and financial institution investments.

Assets which are not a component of or deducted from financial resources fall into either the trading (held with short term trading intent or to hedge such assets) or the banking book and are risk weighted. The risk weighting ensures that the capital required for an asset is in line with the asset's risk profile.

Pillar 1 requires the calculation of credit risk. For credit risk on which non-trading book assets may be risk weighted one of the standardised, Internal Ratings Based (IRB) or the advanced IRB approaches must be adopted (only larger institutions will have the resources to apply the IRB approaches). The credit risk will be netted against credit risk mitigants which include collateral, guarantees and credit derivatives.

Counterparty credit risk (the risk of counterparty default on transactions involving bilateral credit risk) will also be calculated. CRD IV introduces the requirement to include a credit valuation adjustment (CVA) charge to take account of the risk of losses as a result of deterioration of the counterparties under Over the Counter (OTC) derivatives. This is in line with IFRS 13 *Fair Value Measurement* which requires an accounting adjustment for assets to capture counterparty credit risk referred to as a CVA.

Market risk will be calculated in relation to position, counterparty and currency risk of the trading book. Operational risk will also be quantified and subject to capital requirements for the first time.

In order to avoid securitisation being used as a means of regulatory capital arbitrage, the requirements have been enhanced to include due diligence and retention requirements as well as additional capital charges for re-securitisations.

* Total capital must be at least 8% of RWA, of which Tier 1 capital has to be at least 6% of RWA and of which CET 1 capital must be at least 4.5% of RWA

** Financial Institutions are required to hold additional CET 1 capital to meet the capital conservation buffer requirement, the countercyclical buffer requirement and the systematically important buffer if applicable.

Capital Buffers are introduced by CRD IV and apply in addition to the 8% RWA in the formula above and must be met using CET 1 capital. There are two types of buffers, the capital conservation buffer (2.5% of RWA) and the countercyclical buffer (0-2.5% of RWA). In addition a systematic risk buffer of CET 1 capital will be introduced at the discretion of the CBI for global systematically important institutions (GSIIs) and other systematically important institutions (OSIIs). The capital conservation, countercyclical and the systematic risk buffers will increase the regulatory capital requirement for financial institutions and will be phased in over three years from 1 January 2016.

Pillar II

Pillar II comprises two elements. Firstly the requirement for the financial institution to prepare its own Individual Capital Adequacy Assessment Process (ICAAP). Secondly the Central Bank of Ireland (CBI) is required to review the ICAAP, systems and controls of the financial institution as part of the Supervisory Review Process (SREP). Additional capital requirements may be placed on the financial institution as part of the SREP at the discretion of the CBI.

Pillar III

Pillar III is a disclosure regime for financial institutions and requires disclosure over a number of headings including:

LIQUIDITY REQUIREMENTS

The Liquidity Coverage Ratio (LCR) will be required to be calculated from 1 January 2015 in order to address short term liquidity. CRD IV requires institutions to hold a buffer of High Quality Liquid Assets (HQLA) which are unencumbered. An LCR of at least 100% is required in order to meet net liquidity outflows under a 30 day stress scenario. The LCR will be phased in over three years starting with 60% in 2015. It is also intended to introduce a Net Stable Funding Ratio (NSFR) to address long term mismatches of liquidity (eg: short term borrowing to cover long term lending etc) but not until 2018.

LEVERAGE RATIO

The leverage ratio is a new regulatory and supervisory tool which will be introduced first as an additional feature that can be applied on individual institutions at the discretion of supervisory authorities. Institutions will be required to disclose their leverage ratio from 1 January 2015. Reporting obligations for institutions would allow appropriate review and calibration, with a view to migrating to a binding measure in 2018. The leverage ratio is intended to limit the level of leverage a financial institution can take on to ensure its assets are in line with its capital. The leverage ratio is calculated as follows:

{Tier 1 Capital / Average Total Consolidated Assets}

KEY CHANGES

CRD IV has made significant changes to the requirements in relation to the quality and amont of capital. The purpose of CRD IV is to enhance financial stability, safeguard the interests of creditors, enhance the level playing field globally while ensuring international competitiveness of the EU banking sector. At a high-level the key changes are (subject to various transitional provisions):

• Changes to the definition of capital including what is eligible to be included as regulatory capital (and the abolition of Tier 3)

• Enhanced requirements for quantity of capital, which now includes a countercyclical capital buffer and capital buffers for systemically important institutions

• Harmonisation of treatment of items which are reported differently for accounting purposes, known as prudential filters

• Widening of the items to be deducted from regulatory capital

• A basis for new liquidity and leverage requirements

• New rules for counterparty risk

• Changes to the information institutions are required to report under Pillar III including rules on corporate governance and remuneration

• Standardised EU regulatory reporting - referred to as COREP and FINREP. These reporting requirements will specify the information firms must report to supervisors in areas such as own funds, large exposures and financial information.

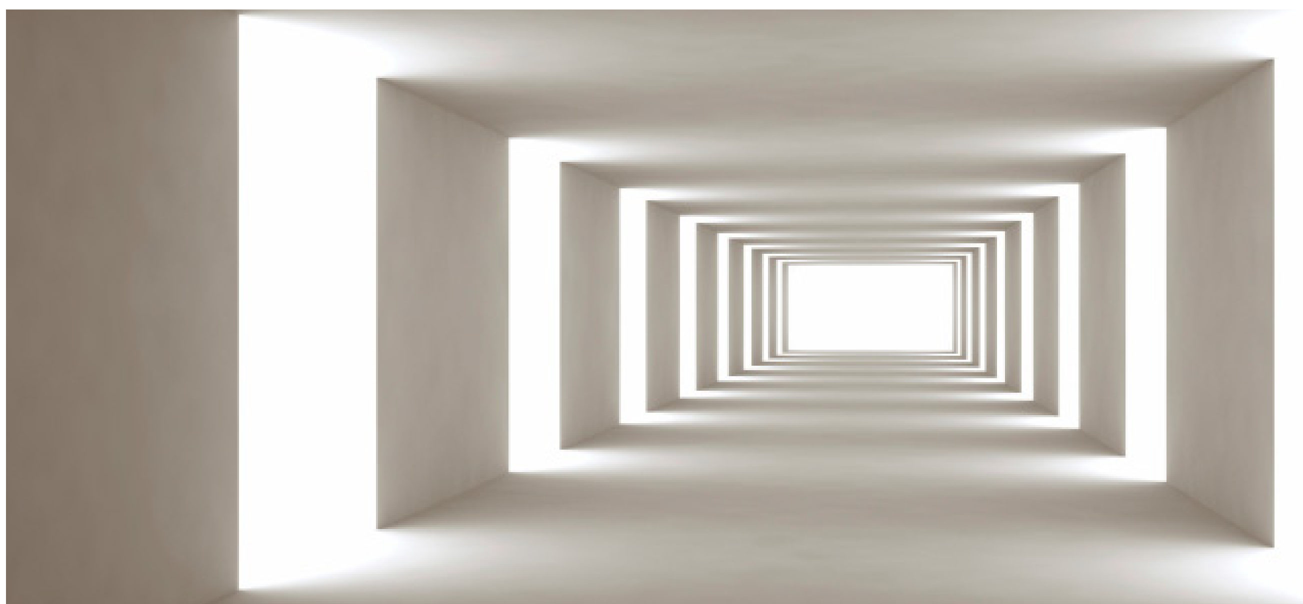
INVESTMENT FIRMS

One interesting aspect of CRD IV is its graded application to MiFID firms based on the investment services they provide. As part of any CRD IV implementation project, we would recommend directors of credit institutions and investment firms consider the type of authorisation they hold and the scope of their activities as this will determine the extent of the application of CRD IV. In considering the application of CRD IV, the definition of under the CRR differs from that under the prior legal framework and that there is now a category of exempt firms. If the following three criteria apply an investment firm may be exempt:

1. Not authorised to provide MiFID ancillary service os safekeeping and administration &
2. Not authorised to hold client money &
3. Only authorised for a combination of MiFID investment services and activities consist only of reception and transmission of orders, execution of orders on behalf of clients, portfolio management and investment advice.

CONCLUSION

Both CRD IV and CRR are highly complex and lengthy documents which promise to completely change the regulatory landscape in the financial sector. As the application date was 1 January 2014, firms have had a limited implementation time and are required to comply with prudential reporting requirements of the Central Bank of Ireland immediately, which is a challenge for not only the larger banks with adequate resources but also the smaller investment firms which may be applying capital requirements for the first time. Some issues remain open to interpretation such as how CRD IV fits with the new IFRS valuation requirements and what impact if any re-hypothecation has on credit risk. The objective of CRD IV and CRR is to make credit institutions and investment firms more stable so that they can withstand economic shocks, thereby improving the financial stability of the sector. Only time and future economic events will tell whether the regulation will be effective in this objective.



MAZARS INSIGHT

BCBS239 : THE NEW CHALLENGE FOR FINANCIAL INSTITUTIONS

BY THIBAUT BINETRUY, SENIOR MANAGER AT MAZARS FRANCE

At the end of the last decade, the crisis which violently undermined the stability of the financial system highlighted the difficulties which banking institutions had experienced in rapidly accessing a consolidated, appropriate and thorough overview of their overall risks.

For some, this lack of visibility was reflected in an inability, particularly in stress periods, to manage their own risk exposure, with severe consequences for themselves and for the system as a whole.

To avoid a repeat of this scenario, in January 2013 the Basel Committee published recommendations (BCBS 239) intended to help the banks to identify and manage their risks better.

The in-depth investigation of bank balance sheets (AQR) launched by the ECB in parallel to BCBS 239 only confirmed and strengthened the obvious need for institutions to be more nimble in their ability to review quality risk data within tight timescales.

BCBS 239, Principles for effective risk data aggregation and risk reporting, mainly targets systemically important banking institutions in order to give them a tool for managing risk data that will enable both banks and supervisory authorities to identify and anticipate the problems.

The Basel Committee recommendations, applicable from 1 January 2016, are based on ten Principles, 11 for financial institutions and three for supervisors.

For banks, the introduction of these Principles will impact the three main aspects of the data management process:

1. THE INFRASTRUCTURE AND GOVERNANCE FOR THE MANAGEMENT AND CIRCULATION OF INFORMATION :

▪ The introduction of a strong **governance** framework should ensure the correct application and respect for the Principles.
▪ The risk data **architecture** and **IT infrastructure** should facilitate the aggregation of risk data, even during times of stress.

2. THE CAPACITY FOR DEFINING, GATHERING AND PROCESSING RISK DATA:

▪ Banks should implement the necessary methods for rapidly communicating **accurate**, **reliable** and **up-to-date** information, on a largely automated basis to reduce operational risks.
▪ These data should be **complete** and **aggregated** at different levels (by asset type, business line, industry, etc.)
▪ Information systems should be **flexible** so as to meet ad hoc data requests, and to take ac-count of external factors.

3. RISK REPORTING PRACTICES :

▪ Like financial statements, risk management reports will give a t**rue and fair** view of a bank's exposure.
▪ Because of the wide range of recipients, reports must be **meaningful** and **tailored to their needs**. Their **frequency** must be set by the board.
▪ Finally, **confidentiality** must be respected where necessary.
The three principles intended for supervisors relate to a single aspect:

PRUDENTIAL SUPERVISION, TOOLS AND COOPERATION BETWEEN SUPERVISORY AUTHORITIES :

▪ Supervisors will have a role to play in **reviewing** and **evaluating** a bank's compliance with the principles, and where necessary will issue recommendations and action plans to im-prove a bank's existing risk management systems.

At the end of the timeline for implementation, the Committee recommends that the application of these principles should be independently assessed by people with specialist skills in information pro-cessing.

The implementation of BCBS 239 represents a major challenge for financial institutions, with impacts on their organisation, procedures and information systems. In response, many banking groups have already launched large-scale programmes.

In initial evaluations, BCBS 239 has revealed the need to tear down the silos in an organisation to ena-ble information to be better shared and better managed.
• Enhanced interrelationships between Finance and Risk information systems have become nec-essary, indeed vital.
• Introducing and sharing a common data template are also among the objectives.

Because of the horizontal nature of the projects to be launched, financial institutions have seized upon BCBS 239 as a real opportunity to re-think their information procedures and systems: the gains will well exceed those originally targeted.

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Praxity MEMBER GLOBAL ALLIANCE OF INDEPENDENT FIRMS

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