Overview

The path to banking supervision in the euro area has become clearer with the release of documents from the European Banking Authority and the European Central Bank. The EBA published standard definitions of forbearance and non-performing loans (NPLs) on 21 October, as well as recommendations for how supervisory authorities should conduct asset quality reviews (AQRs).

Then on 23 October the ECB published details on how it intends to conduct AQRs when it takes over banking supervision under the Single Supervisory Mechanism in 2014. These documents together prepare the ground for the ECB to conduct its review into the balance sheet health of the euro area’s biggest banks – the ECB’s first major task on the road to banking union.

While the EBA’s new definitions have compliance implications for EU banks, the forthcoming AQRs are likely to pose less of a challenge for banks than they will for the ECB and other competent authorities:

- Banks will need to start working on compliance with the EBA’s new supervisory reporting templates, and implementing the new reporting systems.
- However, the AQRs, scheduled to begin in March 2014, will largely be repeating exercises that banks have already undertaken – albeit under a harmonised framework.
- While the AQRs will likely find some holes in bank balance sheets, it is unlikely that they will be of a scale to shift perceptions of euro area periphery banks on the downside – unless there is a severe deterioration in market conditions.
- Nonetheless, AQRs will have tangible benefits for the banks undertaking them – over and above the necessity to meet regulatory requirements.
- Meanwhile, the ECB will face challenges in centralising supervisory powers from national authorities in the absence of a single resolution mechanism.

New definitions

The EBA on 21 October published a draft technical standard that sets out standard definitions for NPLs and for loans subject to forbearance. Establishing these common definitions is a prerequisite in order for an EU-wide assessment of asset quality, to be conducted by the ECB and national authorities, to be able to draw meaningful comparisons between institutions in different EU member states. Previously there was no EU-wide standard definition of forbearance and there was no consistency in recognising or provisioning for NPLs.

The common definitions will help the ECB to take a harmonised approach to AQRs:

- **NPLs.** The key criterion under the new definition is that loans should be considered non-performing when they are more than 90 days past due and/or unlikely to pay.
- **Forbearance.** Forborne loans are, in the new definition, those for which ‘concessions’ have been extended to a debtor facing or about to face difficulties. Such ‘concessions’ can mean either:
  - when terms and conditions are modified in order to help a debtor who is unable to comply due to financial difficulties; or
  - when a debt contract is refinanced as a result of the debtor being in financial difficulties.
- **Overlap.** Forborne loans can be considered performing or non-performing, depending on the circumstances.

The EBA’s new definitions for forbearance and NPLs create tougher standards for assessing NPLs than was previously the case. Having a more precise, consistent definition of NPLs, that replaces the plethora of existing definitions used by banks, means that it is likely a higher proportion of loans will be classified as non-performing overall. Moreover, the technical standards provide supervisors with a supervisory monitoring tool for forbearance activities:

- **Reporting requirements.** Banks will have to implement new reporting requirements and comply with the new supervisory reporting templates. This will mean implementing new reporting systems, which are expected to enter into force in September 2014 – although the remittance date of supervisory reporting templates has been postponed to 31 December 2014. In addition, banks will need to establish new risk management and lending processes, to ensure that transactions are flagged as appropriate.
- **Different implications.** The new definitions will have different implications for different banks in different jurisdictions – depending on what the current methods for asset quality assessment, which vary. For banks in jurisdictions which already have definitions of forbearance and/or NPLs, they may now have to manage two sets of definitions as the national definitions will not automatically be superseded by those of the EBA. This could result in parallel processes, procedures and controls. However, this depends on whether or not national authorities decide to align their definitions to those of the EBA.
Asset quality reviews

The ECB will be going through the balance sheets of 124 of the biggest banks in the euro area to make sure they do not contain hidden losses. The reviews will be undertaken between March and October 2014, so that they can support the EU-wide stress test that will be carried out that year. The purpose of the review is to make sure that each bank’s capital ratio accurately reflects the quality and riskiness of its holding, so that the ECB can begin supervision with confidence in banks’ capital footing.

In the document published last week, the ECB released details about how its euro area assessment will be conducted:

- The ECB will require the banks it supervises to hold a capital buffer of at least 8 per cent Common Equity Tier 1, which is based on CRD IV requirements. However, what counts as capital will change over the course of the assessment: the capital definition of 1 January 2014 will apply for the AQR, while the stress tests will employ the capital definition that is valid at the end of the horizon.

- If the ECB finds under reporting of bad loans or mispriced securities, it will ask the bank to write down the value of those assets and increase levels of capital to cover them.

The central question for the ECB is whether big holes will be identified in bank balance sheets, and whether the subsequent stress tests will be viewed as credible.

Mazars view – informed by our experience of conducting stress tests and AQRs – is:

- **Balance sheets.** The AQRs scheduled for 2014 are unlikely to result in any major revelations about the quality of bank balance sheets. While the ECB’s harmonised approach to conducting asset reviews will allow for comparability and centralised within the ECB, in fact, most of the largest lenders in the euro area have already undertaken numerous AQRs under their national authorities – meaning it is unlikely there is very much new to be found, short of a severe deterioration in market conditions.

- **Benefits of AQRs.** Whilst the largest lenders have already undertaken numerous AQRs, there remain opportunities for the banks to benefit from such an exercise. In our experience, such an exercise will identify systems and controls improvements, opportunities to refine management information and reporting, and contribute to training and development programme enhancements.

- **Preparation for AQRs.** Banks will need to start preparing for exercise. Equity-constrained banks may be likely to prepare for the AQR by reducing assets and using the proceeds to add to equity positions.

Outlook

Key questions remain as to the overall outlook for banks in the euro area periphery and the prospects for banking union:

- **ECB credibility.** The ECB will be keenly aware of the perceived shortcomings of the EBA stress tests that took place in 2011, and will seek to maintain credibility. However, the same problem remains, which is a reliance on national, rather than EU, fiscal backstop if banks are found to need significantly more capital. Furthermore, if they do find some holes, there is also a question mark over whether the ECB has the power to force national authorities to restructure banks – or even shut them down.

- **Long-term repair.** Bank asset quality depends on the economy. Southern European economies will need to get out of recession before bank balance sheets can be fully repaired. The cost of credit in Southern European countries remains at risk of staying high, despite moves towards the integration of supervision.

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