Luis M Linde: Results of the comprehensive assessment of the euro area banking system

Address by Mr Luis M Linde, Governor of the Bank of Spain, at the press conference presenting the results of the comprehensive assessment of the euro area banking system, Bank of Spain, Madrid, 26 October 2014.

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1. Introduction

We have called you here today on the occasion of the publication of the Comprehensive Assessment results for significant banks in the euro area, which has been conducted as a prior step to the start-up of the Single Supervisory Mechanism on 4 November.

I believe the press conference and the material published by the ECB provide a rounded view of the overall results of the exercise. The aim of this conference is to offer you an analysis of the data from the standpoint of the Banco de España, and of the Spanish banking system.

Two clear messages emerge from the information published today:

Firstly, ***at European level,*** despite its great complexity, ***the exercise has unfolded successfully and has met its main objectives: to improve transparency regarding the situation of European banks, to identify potential weaknesses in their balance sheets and contribute to strengthening their solvency.***

Secondly, ***the outcome of the Comprehensive Assessment highlights the fact that the reform and restructuring of the Spanish banking system in recent years has borne fruit, and that Spanish banks now face the future with healthy balance sheets and a sound solvency position.***

2. Brief description of the exercise

Before turning to the results, allow me briefly to recall the nature of the exercise. As you know, the Comprehensive Assessment comprised two components: ***an asset quality review and a stress test.***

Assessing asset quality involved a detailed review of bank balance sheets to determine, among other things, whether the ***classification*** of financial instruments, ***provisioning*** levels and the ***valuations*** of specific assets are appropriate.

The process, conducted in a decentralised fashion, was very complex. It required the support of leading audit firms, and was subject to stringent quality assurance, where the national supervisory authorities – in our case the Banco de España – played a very important role. As a result of this part of the exercise, adjustments were made to the ***level of CET1 (i.e. maximum quality) capital, as defined under the Basel III Accord***, which were taken into account to determine the starting point of the stress tests.

The second key element of the Comprehensive Assessment was the ***stress test***. This is an exercise that seeks to evaluate the resilience of banks in hypothetical scenarios.

The stress test is an exercise basically prepared by the banks themselves, using the so-called bottom-up approach and applying the methodology of the European Banking Authority. The test was subject to strict quality assurance by the ECB and the national supervisory authorities. The exercise assesses the foreseeable position of banks in two scenarios: one, a ***baseline*** or more likely scenario (a macroeconomic scenario approved by the European Commission); the second, an ***adverse*** – and severe but not impossible –

scenario (set by the European Systemic Risk Board), in the period 2014–2016. The consolidated balance sheets at year-end 2013 were taken as the starting point for the exercise.

3. Scope of the exercise

The comprehensive assessment examined 130 banks from 19 countries. The main data from the exercise as follows:

– The assets reviewed account for 81.6% of the total assets of banks supervised by the Single Supervisory Mechanism. The remaining assets, somewhat more than 18.4%, are assets of banks supervised indirectly by the Single Supervisory Mechanism.

– 15 Spanish banks were examined, accounting for 90% of the assets of Spanish deposit-taking institutions.

– Along with teams from all the supervisory authorities, including naturally the Banco de España, consultancies, appraisers, audit firms and, evidently, the banks themselves under examination all participated.

– More than 6,000 experts, 600 of whom in Spain, were involved at the European level.

– For Spain, the cost of the exercise was €32 million in total, of which €11 million correspond to the consultancy, Oliver Wyman, and €21 million to the audit firms and consultancies. Under the terms envisaged in the current Law on the Management, Supervision and Solvency of Credit Institutions, this cost will be borne by the banks, in accordance with the legally established keys and procedures.

As to the total cost of the exercise for the ECB and the supervisory authorities as a whole, I am not yet in a position to provide it. But the cost is high.

4. Assessment of the exercise from an overall standpoint

First, I do believe that having conducted such an exercise in such a short period of time is an achievement in itself. Never to date has a stress test and an asset quality review been combined at the European level.

It is a challenge of the first order, since banks from 19 countries with different supervisory models and different regulatory frameworks were involved. However, thanks to a sound methodology and with rigorous quality assurance processes set in place, both by the ECB and by national authorities, we were able to ensure that the results of the exercise met high standards and were reasonably comparable across banks from different countries.

Moreover, the Comprehensive Assessment is, undoubtedly, a major step forward in terms of transparency, significantly increasing the amount, quality and consistency of the information available about the position of European banks.

5. Minimum levels of capital required.

a) Minimum thresholds of common equity tier 1 (CET1) capital were set, as defined under the Basel III Accord, that have to be exceeded both in the comprehensive assessment, and in the baseline scenario of the stress test (8%); and another minimum threshold that has to be exceeded in the adverse scenario of the stress test (5.5%).

b) The banks falling short have to submit, within two weeks, a recapitalisation plan to be implemented within six months (if the capital shortfall arises from the asset review or from the baseline scenario in the stress test) or nine months (if the capital shortfall arises from the adverse scenario).

6. Results at the European level

The results just disclosed show that, according to the methodology used, in the banking systems as a whole that are to be supervised by the Single Supervisory Mechanism – the ECB and the National Supervisory Authorities – 25 banks have a capital shortfall, assessed against the three thresholds set (in the AQR and in the baseline and adverse scenarios of the stress test).

Of these 25 banks, 12 have already increased capital in 2014 to make good the shortfall, meaning there are only 13 banks that have to submit their plans to redress capital inadequacy.

In total, the shortfall of these 25 banks amounted to €24.6 billion, but bearing in mind the capital increases already made, the shortfall currently stands at only €9.5 billion.

7. Outcome of the exercise for Spanish banks

a) Of the 15 Spanish banks assessed, 14 have passed the examination, i.e. they exceed the minimum capital required in the three phases of the exercise. One bank, Liberbank, does not reach the minimum 8% ratio set for the comprehensive assessment, standing at 7.8%, i.e. 0.2 pp below the minimum required.

b) This bank has already concluded a capital increase for an amount exceeding €600 million, meaning that it has already made good the shortfall.

c) The remaining banks comfortably meet the minimum requirements in all the phases of the exercise.

8. Interpretation of the results

The result of the asset quality review – which, unlike the stress tests, is not based on scenarios or future assumptions, but is a detailed review of the balance sheets at end-year 2013 to verify that they give a true and fair view of the position of the banks – shows that it is the Spanish banks that have had to make fewer adjustments, less than 0.2% of risk-weighted assets.

The findings of the stress tests are somewhat more difficult to compare, because the scenarios used differ from country to country. But the results obtained show that all the Spanish banks would be resilient in a hypothetical, very severe scenario.

In recent years, Spanish banks have substantially written down real estate development-related assets, especially following the requirements of Royal Decree-Laws 2/2012 and 18/2012. Additionally, in the second half of 2012 they were subject under the Assistance Programme for Spain’s financial system agreed with the European Union to an exhaustive accounting review and a stress test, the result of which led to the recapitalisation and restructuring of certain banks. Moreover, during 2013 several measures were taken to ensure that adequate provisioning levels were maintained, which included, most notably, the review of refinanced and restructured loans.

– As a result of the criteria issued by the Banco de España in 2013 for the proper classification of these operations, Spanish banks reclassified under an inferior category operations amounting to €26 billion, which required approximately €5 billion of additional provisions.

– To sum up, between 1 January 2008 and 30 June 2014 the provisioning drive by Spanish banks amounted to €277.65 billion, that is to say, provisions amounting to the equivalent of 25% of Spain's GDP in 2013.

Given all these measures, the starting point for Spanish banks was expected to be generally better than that of those in the other European countries as a whole regarding the more demanding criteria for recording assets. And, the outcome of the Comprehensive Assessment which has just been published confirms these expectations.

9. Conclusions

The disclosure of the results today marks the end of a period of just under one year in which all the parties involved – the ECB, the national authorities, the auditors and the banks themselves – have made a sterling effort.

However, today marks not an end, but a beginning. In just over a week the Single Supervisory Mechanism will become fully operational, and the immediate future poses challenges of the first order both for supervisors, involving the adaptation of our structures and functioning to the needs of the new European mechanism, and for banks.

I would not like to conclude without thanking the whole team at the Banco de España, which has been working for months in collaboration with the European Central Bank, the banks and the audit firms to successfully see through this complex exercise. And, naturally, I would also like to extend my thanks to the teams at all of the banks which, for months, have devoted their best technical capabilities to this end.

Thank you very much for your interest and for being here today.