SILVERCREEK
CAPITAL MANAGEMENT

VIEWPOINT

Asset Quality Review: Key Findings and Potential Implications

November 2014

On October 26, 2014, the European Central Bank ("ECB") released the highly anticipated results of the Asset Quality Review ("AQR"), a comprehensive year-long assessment of the financial health of the European banking system. In the months preceding its release, significant sales of non-performing loans ("NPLs") and other non-core assets as well as capital raises occurred, already creating a significant impact. While the market continues to digest the report's findings, below we highlight the key results, as well as provide our initial assessment of its potential implications.

SUMMARY OF KEY FINDINGS

Following the 2008 global financial crisis, the ECB and other governing bodies conducted a number of studies of the financial health of European banks. However, these studies had limited impact, having been stymied by credibility issues. Cognizant of this backdrop, the ECB went to significant lengths to be transparent in methodology and broad in reach in designing and executing their comprehensive assessment.

The assessment was comprised of two parts: the AQR and a forward-looking stress test. The AQR applied a uniform methodology and common definitions to analyzing the balance sheets of 130 of Europe's largest banks. Accounting for approximately 82% of European bank assets, this point-in-time analysis was conducted as of December 31, 2013.[i] The analysis was complemented by forward-looking stress tests that the ECB conducted in concert with the European Banking Authority. A bank's resiliency to a base-case and adverse scenario was tested. (In the base-case, the EU economy develops in line with ECB's projections through 2016, whereas in the adverse scenario, overall macroeconomic conditions deteriorate significantly). Banks were required to maintain an 8% Common Equity Tier 1 ("CET1") ratio under the base-case scenario and 5.5% CET1 ratio under the adverse scenario.[ii] Of note, the results from the AQR (including adjustments of book values) were reflected in the stress tests. This integration of the two tests – which the ECB described as a "join-up" – was unprecedented and a key measure taken to strengthen the study's results.

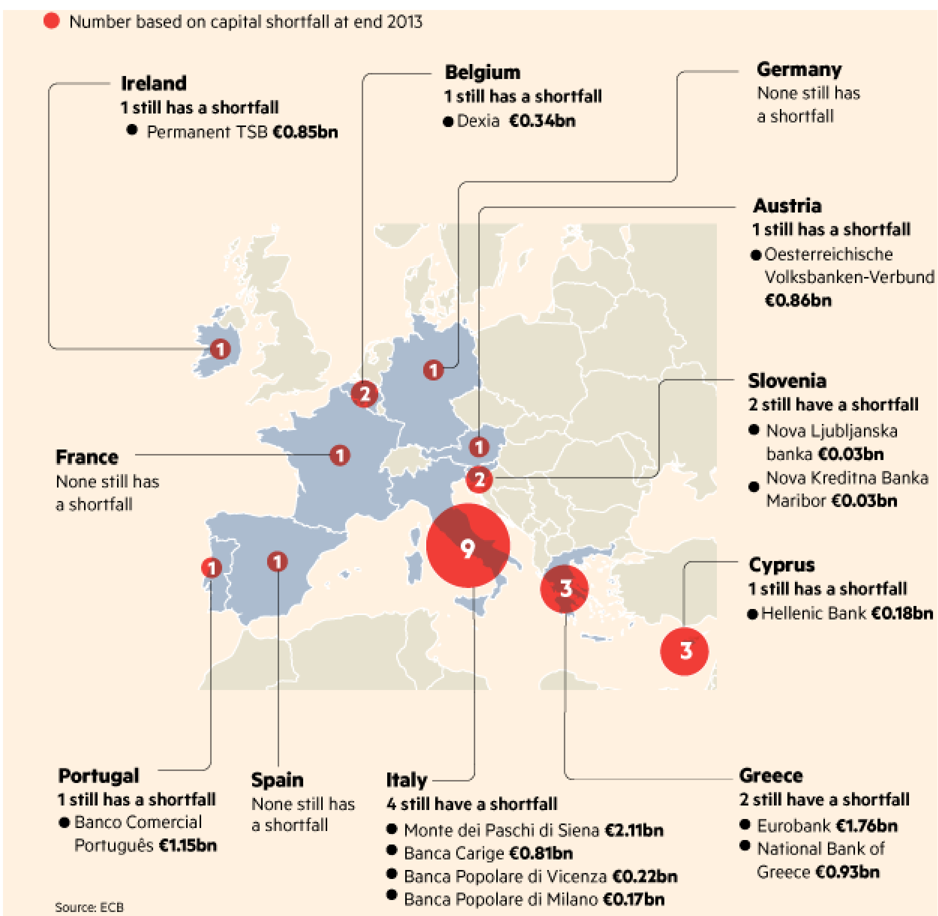
Banks with capital shortfalls were required to submit capital plans to the ECB by November 10, 2014, approximately two weeks after the report's release. Banks will then be required to implement the agreed-upon measures to address the shortfalls within defied time periods: 6 months (end of April 2015) for shortfalls identified in the AQR or baseline stress test, and 9 months (end of July 2015) for shortfalls identified in the adverse stress test.[iii] Furthermore, the results are being used by the ECB in on-going supervision of the underlying banks, including capital adequacy requirements.

KEY FINDINGS

Below is a summary of the key findings of the comprehensive assessment.

- **Capital Shortfall**. An aggregate €25 billion capital shortfall across 25 participant banks as of December 2013 was reported.[iv] Twelve banks have already covered their shortfall, raising €15 billion in capital in 2014. An additional 5 banks have “passed” as the result of announced restructurings or wind-downs. *This brings the number of banks that must submit detailed capital plans to 8, representing €6 billion.* [v]
- **NPLs.** An additional €136 billion in NPLs were identified, bringing the total to €879 billion. (€55 billion as the result of the harmonization of divergent definitions and €81 billion observed increase).[vi]
- **Adjustments.** The AQR resulted in gross asset adjustments of €48 billion of which €37 billion did not generate a capital shortfall.[vii]
- **Stress Test**. Under the adverse scenario, a capital shortfall of €24.2 billion was reported. The number reduces by over half to €10.2 billion when factoring in mitigating factors that banks have taken in 2014.[viii] (Debate remains in the analyst community regarding the stress tests -- whether various hurdles are “phased in” versus “fully phased”).[ix]
- **Geography.** On a country basis, shortfalls are concentrated in Greece (€11 billion pre-mitigations; €2.9 billion post-mitigations) and Italy (€10 billion pre-mitigations; €3.4 billion post-mitigations).[x] Germany had no banks with a capital shortfall as illustrated below.

STRESS TEST RESULTS - BANK FAILURES BY COUNTRY[xi]



POTENTIAL IMPLICATIONS

The comprehensive assessment has already had significant implications in terms of both capital raises and asset sales. Since its announcement in July 2013, European banks have raised over €60 billion though gross equity issuances and an additional €44 billion through internal capital generation.[xii] The sale of NPLs and other non-core assets have also increased significantly. In 2013, the total number of European bank transactions of non-core assets was €64 billion, up from €46 billion in 2012 and €36 billion in 2011.[xiii] As of June 2014, over €44 billion in loan portfolios have transacted and estimates are that €87 billion in transactions are likely to close by year-end.[xiv] Investment managers have repeatedly cited the AQR as the primary driver for the increase in NPL sales. In aggregate, the ECB reports that the total amount of balance sheet strengthening from July 2013 to August 2014 was €203 billion.[xv]

On a prospective basis, the potential implications of the AQR and stress test result stem, in part, from expectations. Goldman Sachs published a survey in early September which indicated that the market expected 8 banks to fail, totaling a capital shortfall of €45 billion.[xvi] The results were significantly different: the actual number of bank failures turned out to be higher but the aggregate capital shortfall was notably lower. With results split, the market reaction to date has been muted. Select bank stocks have traded off significantly (including Monte del Paschi di Siena, which traded off nearly 20% on November 3, 2014).[xvii] Overall, however, the Euro was largely unchanged following the announcement, rising 0.2% versus the U.S. dollar.[xviii]

Some industry participants have speculated that one of the long-term implications of this comprehensive assessment will possibly be a wave of cross-border bank consolidation. We believe it is too soon to opine on any long-term implications as the results continue to be digested. Nonetheless, we think the AQR has already had a significant impact through front-loaded measures as discussed above. Additionally, we believe the ECB has achieved its objective of providing greater transparency, and we believe that the measures taken that allow for greater comparability across countries in terms of key risk measures is a notable improvement. One of the key outcomes was the increase in NPLs, which augurs well for continued opportunities in that space.

CONCLUDING THOUGHTS

Silver Creek has been actively investing in private credit opportunities including NPLs on behalf of its investors since before the global financial crisis. It is our view that the AQR, coupled with other regulatory-driven measures to re-capitalize European financial institutions, creates a greatly improved environment for many private credit investments. It is in this strong environment – of enhanced supply and limited investor capital – that Silver Creek anticipates raising its 2015 vintage of private credit investment funds.

[i] Source: *Aggregate Report on the Comprehensive Assessment,* ECB, October 2014
[ii] *Id.*
[iii] Source: *Comprehensive Assessment: Final Results Press Conference*, ECB, October 2014
[iv] *Id.*
[v] Source: Goldman Sachs Global Investment Research, *AQR/test: Sharp improvement in transparency; capital debate unlikely to end*, October 2014
[vi] Source: *Comprehensive Assessment: Final Results Press Conference*, ECB, October 2014
[vii] *Id.*
[viii] Source: Goldman Sachs Global Investment Research, *AQR/test: Sharp improvement in transparency; capital debate unlikely to end*, October 2014
[ix] *Id.*
[x] Source: *Comprehensive Assessment: Final Results Press Conference*, ECB, October 2014
[xi] Source: *Financial Times, "Monte dei Paschi shares tumble 20%," 10/27/14*
[xii] Source: *Comprehensive Assessment: Final Results Press Conference*, ECB, October 2014
[xiii] Source: PwC European Portfolio Advisory Group Market Update, July 2014
[xiv] *Id.*
[xv] Source: *Comprehensive Assessment: Final Results Press Conference*, ECB, October 2014
[xvi] Source: Goldman Sachs Global Investment Research, *AQR/test: Sharp improvement in transparency; capital debate unlikely to end*, October 2014
[xvii] Source: *Financial Times, "Monte dei Paschi shares tumble 20%," 10/27/14*
[xviii] *Id.*

ABOUT THE AUTHOR

MARY BATES is the Director of Credit Strategies at Silver Creek. Her responsibilities include underwriting and monitoring credit-focused strategies as well as communicating Silver Creek's strategies externally. Prior to joining Silver Creek, Ms. Bates spent over eleven years at Hewitt EnnisKnupp where she most recently served as a Senior Research Consultant on the Liquid Alternatives team, focused on credit-related hedge funds. While at HEK, Ms. Bates worked with some of the largest institutional plan sponsors in the industry on their hedge fund programs, advising on portfolio construction, manager selection and program design. She also was a key team member of the manager selection phase of the Public-Private Investment Program (PPIP) of Troubled Asset Relief Program (TARP). Prior to joining Hewitt EnnisKnupp, Ms. Bates began her career at Lehman Brothers where she was an analyst on the emerging market debt desk. Ms. Bates holds a B.S. in Business Administration with a concentration in finance from Indiana University.

Mary Bates, Director
206. 774. 5980
mary@silvercreekcapital.com

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CONTACT US

TOLL FREE:	1.866.774.1122	**OFFICE:**	1301 Fifth Avenue, 40th Floor
EMAIL:	investorreporting@silvercreekcapital.com		Seattle, Washington 98101
WEBSITE:	www.silvercreekcapital.com		T | 206. 774. 6000
			F | 206. 774. 6010

CONTACT:	**Bob Ratliffe**, Managing Director	bob@silvercreekcapital.com	206.774.5996
	Mary Bates, Director	mary@silvercreekcapital.com	206.774.5980
	Brian Hanson, Director	bhanson@silvercreekcapital.com	206.774.6005

[1] Silver Creek Capital Management LLC ("Silver Creek US") was organized in 1999 as the successor entity to offer other fund of fund products in addition to the original fund established by the founders of Silver Creek US in 1994.

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