SREP 2019: WHAT CAN BE LEARNT FROM THE OUTCOMES OF SREP 2018

May 2019

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2 ABSTRACT

As part of the Single Supervisory Mechanism ('SSM'), the Supervisory Review and Evaluation Process ('SREP') aims to promote a resilient banking system and involves a comprehensive assessment of banks' strategies, processes and risks, and takes a forward-looking view to determine how much capital and liquidity each bank needs to cover its risks.

In 2018, the SREP was executed for the fourth time for SIs in 19 countries according to a common methodology and decision-making process, allowing for peer comparisons and transversal analyses on a wide scale.

As with previous years, four main areas were assessed and scored under the SREP exercise, including the assessment of:

1. The viability and the sustainability of institutions' business model through the Business Model Assessment ('BMA').
2. The governance and the risk management framework.
3. Risks to capital.
4. Risks to liquidity and funding.

This briefing note aims to present and analyse the key facts and main outcomes of SREP 2018, as applicable in 2019.

3 OVERVIEW

While the SREP framework remains robust and serves the purpose of ensuring the convergence of supervisory practices, the outcomes of the 2018 exercise allows the ECB to highlight and or confirm the key areas of vulnerabilities and risks which are faced by the banking sector. While the overall aggregate risk profile remains stable compared to previous years, several issues remain points of attention, including:

- Institutions' profitability ;
- The high level of NPL; and ;
- ICAAPs and ILAAPs which still need to be further improved.

The overall SREP outcome for 2018 remains pretty stable compared to 2017 as 52% of the sample of the 107 banks gets a grade of 2, 36% a grade of 3 and only 12% a grade of 4 (the worst possible grade). As a result, the overall CET1 demand (excl. systemic buffers) increases slightly from SREP 2017 to 2018, including an increase by 10 bps of the P2R and the P2G. While SREP CET1 per score remains comparable to 2017, SREP 2018 CET1 increases consistently with worse SREP scores.

In this paper, the following areas of focus resulting from the SREP 2018 exercise are presented in more detail:

- SSM risk map.
- SREP scores breakdown and evolution.
- Capital measures and other additional measures.

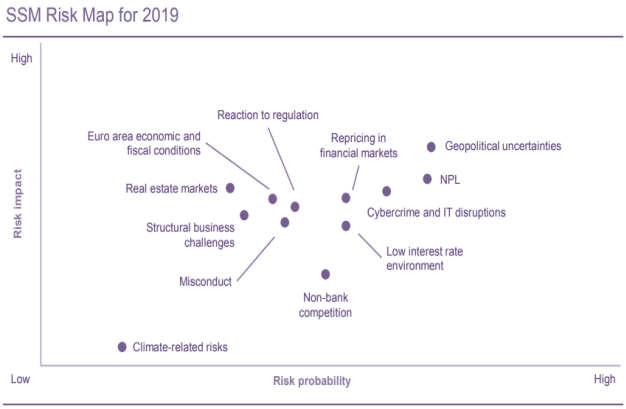
4 MAIN AREAS OF FOCUS

In this section, the key outcomes of the SSM SREP 2018 highlighted by the ECB are presented and described.

SSM risk map

The identification and assessment of the risks faced by supervised entities are used to ensure adequate banking supervision and serves as a basis for defining the SSM supervisory priorities.

Key results of this assessment are shown in the SSM Risk Map (see Figure below) which shows an aggregated picture of the euro area and depicts the key risk drivers affecting the euro area banking system over a two to the three-year horizon along the dimensions of probability and impact. The risk drivers should not be seen in isolation as they may trigger or reinforce each other.



The three most prominent risk drivers affecting the euro area banking system are:

- Geopolitical uncertainties;
- The stock of non-performing loans (NPLs) and potential build-up of future NPLs; and :
- Cybercrime and IT disruptions.

i. Geopolitical uncertainties

Political uncertainties have increased in the recent period, mainly due to the Brexit as the final shape of the transition, and the withdrawal agreements remain to be approved. Brexit-related concerns encompass a wide range of risks, such as business continuity and transitional risks, contract continuity, and risks of regulatory arbitrage related to national differences in regulation or risks of macroeconomic repercussions. There is a limited risk of a significant disruption of access to the financial services for the euro area, but a potential fragmentation of the financial services industry could inhibit its efficiency.

ii. NPL (Non-performing loans)

Despite a significant improvement in asset quality over the recent years, high levels of NPLs remain a concern for a significant number of euro area institutions, and the high aggregate level of NPLs remains elevated by international standards. High stocks of NPLs constrain banks' balance sheets, profitability and capital. It has to be put in perspective with institutions' ongoing search for yield along with still subdued profitability, which might result in excessive risk-taking and future NPLs.

iii. Cybercrime and IT disruptions

Cybercrime and IT disruptions create an increasing challenge for banks and highlight the need for them to invest in IT systems as banks are currently forced to modernise their core IT infrastructure to enhance the quality of customers' experience and become more efficient, also to compete with fintech/bigtech companies. Moreover, banks face a growing number of cyber threats as cyber incidents can lead to financial losses, further indirect ramifications and can even have a systemic impact, although significant institutions have so far not reported any major incident. To conclude, advances in digitalisation exacerbate the risks related to banks' legacy IT systems and cyber-attacks.

Evolution of SREP scores

The overall 2018 SREP outcome showed that banks' governance and risk management worsened from the previous SREP cycle, while the assessment of banks' management of liquidity and funding risks remained stable even though areas of improvements are identified. The risk management framework of several banks should continue to improve as many of them are facing challenges, notably in risk infrastructure, data aggregation and reporting capabilities, and internal audit.

i. Business model assessment

Euro-area banks have improved their profitability in recent years. Their return on equity reached 6% at the end of 2018, up from 3% two years earlier. But their profitability remains below their long-run cost of capital, which most banks estimate to be in the range of 8-10%[1]. European bank profitability has been structurally weak since well before unconventional monetary policy measures were introduced. The sources of that weakness can be divided into cyclical factors, cost inefficiencies and competitive challenges arising from outside

[1] See European Banking Authority (2018), Risk Assessment Questionnaire – Summary of Results, December.

the sector. It will remain a key area of focus for the ECB in the medium term. The results in this domain are stable compared to the previous years.

ii. Governance and Risk Management

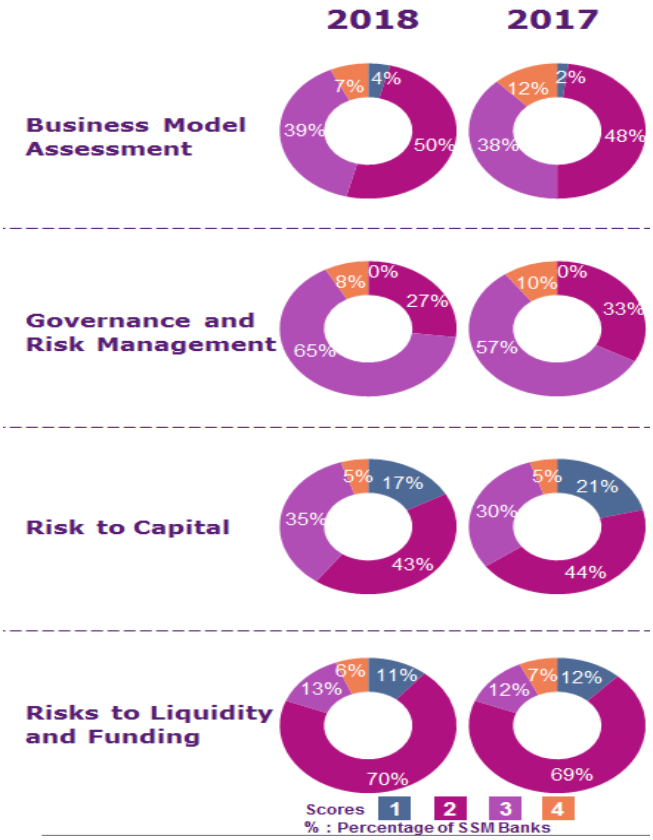
Regarding corporate structure and organisation, deficiencies in internal control frameworks remain, as well as insufficient human resources and lack of coordination. Further findings concern the role and responsibilities of the management body. Indeed deficiencies and weaknesses remain in the delegation of powers and the implementation of the institution's strategy and governance arrangements. Additionally, findings are identified on the status, resources and scope of activity of all internal control functions. Globally, the number of banks scoring Grade 3 has increased from 57% to 65% compared to the previous year, showing that the ECB's appreciation of the level of institutions' governance and risk management have worsened.

iii. Risks to Capital

In terms of risks to capital, high levels of NPL are still a point of attention. The ECB continues to address the stock of NPLs to ensure continued progress to reduce legacy risks and achieve consistent coverage of the stock and flow of NPLs over the medium term. Besides, the ECB keeps reviewing the quality of institutions' ICAAPs and considering it as a fundamental part of the SREP. While improvements have been made across institutions, several areas still have to be improved including capital management governance, the inclusion of ICAAP outcomes in the strategic decision-making process, risk coverage and risk quantification methodologies, and the linkage between the normative and the economic approaches. Banks are expected to assess the risks they face and, in a forward-looking manner, ensure that all material risks are identified, effectively managed and covered by adequate capital levels at all times. In November 2018, the ECB published its expectations regarding institutions' internal capital adequacy assessment process aiming to incentivise banks to improve their ICAAPs. In 2019, it will intensify its supervisory assessments, and it will further increase the role the ICAAP play in the SREP. For example, the ICAAP will play an enhanced role in the determination of Pillar 2 own funds requirements on a risk-by-risk basis, following an individual assessment of each bank. Globally, the number of Banks scoring grade 3 has increased from 30% to 35% compared to the previous year, showing that ECB's appreciation of the level of institutions' risk to capital has worsened.

iv. Risks to Liquidity and Funding

The ECB also reviews the quality of institutions' ILAAPs and considers it as a fundamental part of the SREP. To this stage, the ILAAP is not necessarily considered by institutions' in the same way as it is in the ICAAP. In several institutions', the ILAAP is more or less constituted of assembling components already existing in the ALM department. For the past years, several areas of improvements have been identified in institutions' Funding and Liquidity risk management framework. For example, most of the institutions' have poor or partial risk driver analysis aiming to identify the key liquidity risk drivers to which the institution is exposed, and which impact its liquidity balance sheet. Liquidity stress testing process is also partial, not well-integrated into institutions' liquidity management and not consistent among institutions. In November 2018, the ECB published its expectations regarding institutions' internal liquidity adequacy assessment process aiming to incentivise banks to improve their ILAAPs. In 2019, it will intensify its supervisory assessments, and it will further increase the role the ILAAP plays in the SREP. Besides, the 2019 stress test will seek to assess banks' resilience against liquidity shocks as individual banks' stress test results will inform the SREP assessments. Globally, all grades assigned to supervised Banks remain stable compared to last year as the grade 3 concentrates roughly 70% of the sample.



Capital measures and other additional measures

Driven by worse SREP scores and the last step of the phase-in of the capital conservation buffer, the total SREP requirement for common equity tiers 1 (CET1)[2] capital increased to 10.6% in 2018 from 10.1% in 2017. Among all banks under the scope, most significant institutions already have capital levels above CET1 levels and buffers required by the EBA. The overall SREP CET1 demand (excluding systemic buffers) slightly increases compared to last year:

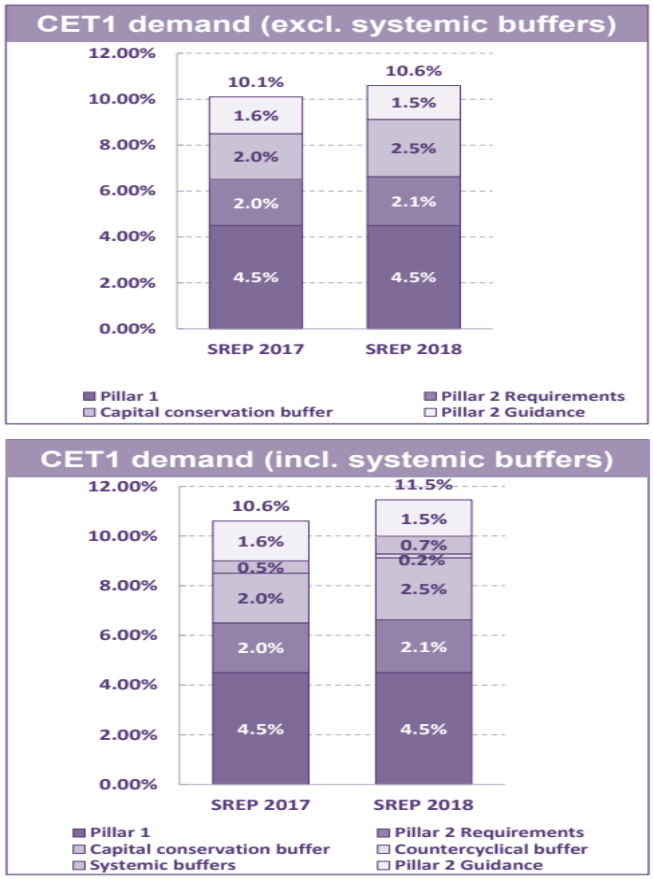
- The phase-in of the CCB counts for on average +50 bps
- The P2R increases by 10 bps
- The P2G decreases by 10 bps.

Banks have increased their CET1 ratios from 11.3% at the end of 2014 to 14.1% in 2018. Over the most recent reporting periods, capital ratios have been stable on average. The total capital ratio3 stood at 17.83% in the third quarter of 2018, slightly down from 17.97% one year previously. A similar development can be observed for the CET1 ratio, while the Tier 14 ratio increased from 15.32% in the third quarter of 2017 to 15.40% in the third quarter of 2018.

While performing the review, supervisors identified a substantial number of banks to which liquidity related measures should apply. Among the banks identified, the liquidity risk management presents significant weaknesses, yet the large majority of them have been identified with qualitative liquidity SREP requirements such as ILAAP and Stress testing Framework. Other qualitative measures apply to more than eighty banks under the scope, notably ICAAP, NPL and IT/data quality.

5 CONCLUSION

The latest SREP cycle results have shown a decline in bank's governance and risk management in comparison to the previous cycle, while the assessment of banks' management of liquidity and funding risks remained largely unchanged, with roughly 70% of institutions achieving a grade of 3 out of 4. Therefore improvements are still expected for the SREP 2019 cycle for many banks. A number of quantitative and qualitative measures regarding governance, controls, methodologies, forecasting abilities, integration to strategic processes and IT infrastructure have been identified and should be addressed by institutions. The key point for improvement is the strengthening of banks strategic tools as ICAAP and ILAAP, which are to play an even bigger role in the SREP and spur institutions enhancing their internal processes.



6 ABOUT AVANTAGE REPLY

Avantage Reply (a member of the Reply Group) is a pan-European specialised management consultancy delivering change initiatives in Risk, Compliance, Finance (Capital Management and Regulatory Reporting), Treasury and Operations within the Financial Services industry.
Within our core competencies, we have extensive experience in implementing changes driven by:

- Industry-wide legislative and regulatory initiatives (e.g. CRD, BRRD);
- Mergers, Acquisitions & Divestments (e.g. business combination, separation and flotation); and
- Business improvement and optimisation agendas (e.g. risk appetite and capital allocation).

[2] *Common Equity Tier 1 (CET1) Capital which represents the highest quality of capital, and is essentially composed of common shares and retained earnings*

[3] Total capital is the sum of Tier 1 capital and Tier 2 capital.

[4] Tier 1 Capital is decomposed into: CET1; and Additional Tier 1 (AT1) Capital which comprises capital instruments that are subordinated, have fully discretionary non cumulative dividends/coupons and have neither a maturity date nor an incentive to redeem.

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