SREP 2020: INSIGHTS AND ANALYSIS FROM THE OUTCOMES

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Introduction

Overview

The **Supervisory Review and Evaluation Process** (SREP) is an annual exercise through which the European Central Bank (ECB) executes, in a forward-looking way, the assessment of banks' business models, governance, risk management arrangements and capital and liquidity profile to form a view of their viability and sustainability and any potential threats to the financial system. This process allows the ECB to set individual capital and liquidity requirements and to provide supervisory guidance for each bank.

Main outcomes of the SREP

1) Holistic - Forward-Looking assessment of the overall viability of the institution.
2) Issuance of a decision, requiring banks to meet their capital/liquidity requirements and implement other supervisory measures.
3) Input to the determination of the minimum level of supervisory engagement for a specific institution as part of the next Supervisory Examination Programme (SEP)

SREP evolution

- In 2015, the SREP was carried out according to a common methodology for banking groups in the Euro area:
  - A holistic assessment of institutions' viability, taking a forward-looking perspective was conducted.
  - Quantitative and qualitative elements were combined through a constrained expert judgement approach.
  - Extensive peer comparisons and transversal analyses were possible on a wide scale for the first time, allowing all institutions to be assessed in a consistent manner and thus promoting a more integrated single banking market.
- Since the 2019 SREP assessment, the methodology has been revised by the European Banking Authority (EBA) on 19th July 2018 (EBA/GL/2018/03).
- The revisions to the SREP Guidelines reflect aspects that came into force after the publication of the original SREP Guidelines in 2014, such as:
  - the introduction of Pillar 2 capital guidance;
  - the integration of supervisory stress testing requirements; and
  - further details on the articulation of total SREP capital requirements (TSCR) and overall capital requirements (OCR).

Main features of the ECB's pragmatic 2020 SREP

1) Focusing on **how banks are handling the challenges** and risks to capital and liquidity arising **from the ongoing Covid-19 induced crisis**

2) **Keeping Pillar 2 requirements (P2R) stable**, unless changes are justified by exceptional circumstances affecting an individual bank

3) **Keeping Pillar 2 guidance (P2G) stable**, reflecting the postponement of the EBA stress test exercise

4) **Maintaining previous SREP scores**, unless justified by exceptional circumstances affecting an individual bank.

5) Addressing supervisory concerns mainly via **qualitative recommendations**

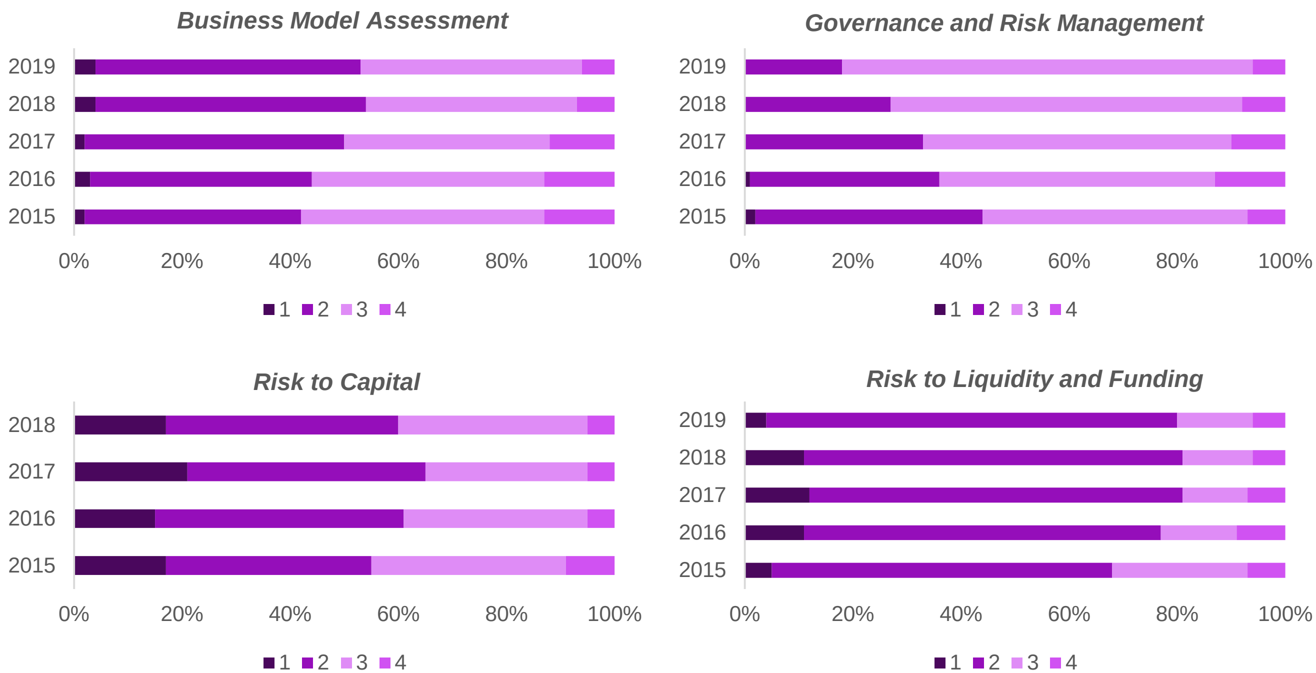
6) Following a pragmatic approach to collecting information on **the ICAAP and the ILAAP**

Evolution of the SREP results – SREP scores (1/2)

Main elements assessed by the SREP

1) **Business Model and Profitability** - the viability and sustainability of business models
2) **Internal Governance and Risk Management** - the adequacy of internal governance and risk management
3) **Risk to Capital** - the risks to capital (with its sub-components of credit risk, market risk, interest rate risk in the banking book and operational risk)
4) **Risks to Liquidity and Funding**

***Figure 1**: SREP Score by Element*



The assessment of each element leads to an element-specific score ranging from 1 to 4 (1 being the best score, 4 being the worst) for every bank which is combined into an overall score ranging again from 1 to 4, in line with the EBA's guidelines on SREP.

Figure 1 illustrates how banks have been performing in each of the four elements from 2015 to 2019. The **key highlights** are:

- Banks have been encouraged to increase profitability through strategic overhauls to improve banks future resilience and sustainability of their business models.
- Governance scores have deteriorated over the last 5 years with a c.45% increase in banks scoring 3 or worse. This is due to ineffective management bodies, weak internal controls etc.
- Non-Performing Loans (NPL) have diminished by a c.50% over the last 5 years, highlighting the effectiveness of the supervisory actions.
- The improving Risk to Liquidity scores over the last 5 years show an overall good liquidity position for banks.

Evolution of the SREP results – SREP scores (2/2)

Business Model Assessment

- Scores have gradually improved from 2015 to 2019.
- In 2020, profitability fell mainly owing to higher impairment flows, lower net interest income, and a decline in fees and commissions.
- Supervisors are increasingly focusing on banks' future resilience and sustainability of their business models.
- Decreasing margins increased the pressure on banks to adjust their costs, leading to several cost-cutting measures throughout 2020, i.e. consolidation of branches and remote working arrangements.
- Recent Covid-19 events have pushed the trend towards digitalisation of internal processes.

Governance and Risk Management

- Governance scores have deteriorated over recent years, with four out of five banks scoring three or worse in 2019.
- Supervisors will intensify assessments of the sustainability of business models and will continue to require banks to enhance the effectiveness of their management bodies and to strengthen internal controls and risk management.

Risk to Capital

- The NPL's held by Significant Institutions (SI's) have decreased from around €1 trillion (8% NPL ratio) to € 543 billion (3.4% NPL ratio) over the last 5 years before the start of the Covid-19 pandemic.
- Due to the pandemic and the resulting deterioration of the economy, the pace of the ongoing reduction in NPLs has been adversely impacted.
- The current level of distress in the loan portfolio, which is not yet fully evident, may come to fruition by the first half of 2021 due to the phasing out of fiscal support measures.
- In order to minimise this impact, there will be an enhanced supervisory focus on banks ensuring they are adequately classifying and measuring risks in their balance sheets and are operationally prepared to address distressed debtors promptly.

Risk to Liquidity

- Scores have gradually improved from 2015 to 2019 and in general show a good liquidity position for banks.
- A Liquidity Stress Test exercise carried out by the ECB to assess banks' ability to withstand hypothetical idiosyncratic liquidity shocks revealed that two main outcome metrics affected the Risk to Liquidity scores. These were the survival period, which corresponds to the first day in which the net liquidity position (NLP) turns negative, and the cliff effect, which measures the difference in the NLP between day 35 and day 30.

Evolution of the SREP results – CET1 ratio

The amount of Common Equity Tier 1 (CET1) capital that directly supervised banks are expected to hold as determined by the SREP was broadly stable from 2016 to 2017.

The overall SREP demand for CET1 capital increased to 10.6% in 2018 from 10.1% in 2017. This increase was driven by:

- The final phase-in of the Capital Conservation Buffer by an average of +50 bps
- The Pillar 2 Requirements (P2R) increased by 10 bps
- The Pillar 2 Guidance (P2G) decreased by 10 bps

Also highlighted is the phase-in process of the Capital Conservation Buffer from 2016, and the proportionate decrease in existing P2G between these years where it is sufficient to accommodate otherwise the Capital Conservation Buffer was supplemented on top.

The CET1 component of the SREP requirements and guidance (excluding systemic buffers and the countercyclical capital buffer) had been fairly stable in the 2018/2019 cycle. The 2020 cycle decreased from around 10.6% to 9.6% in light of the Covid-19 capital relief and due to the frontloading of the new rules originally scheduled to come into force with the Capital Requirements Directive V (CRD V) on 1 January 2021.

The new rules state the Pillar 2 Requirements (P2R) should have the same capital composition as that of Pillar 1 i.e. P2R should be held with at least 56.25% in CET1 and 75% in Tier 1 as a minimum requirement, such that the P2R CET1 component has now decreased to 1.2%.

***Figure 3**: Quarterly development of CET1 ratio*

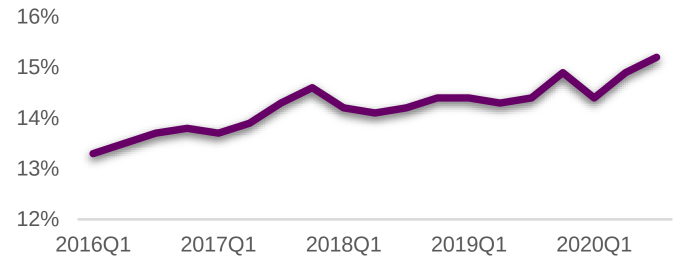


***Figure 4**: Quarterly development of LCR*

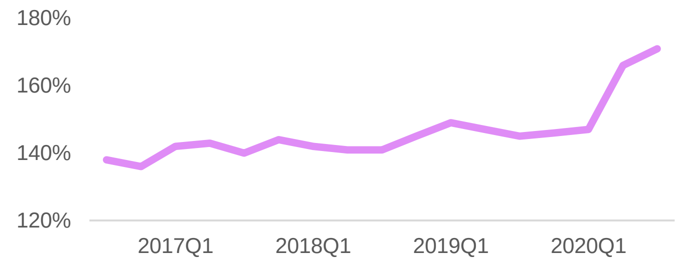
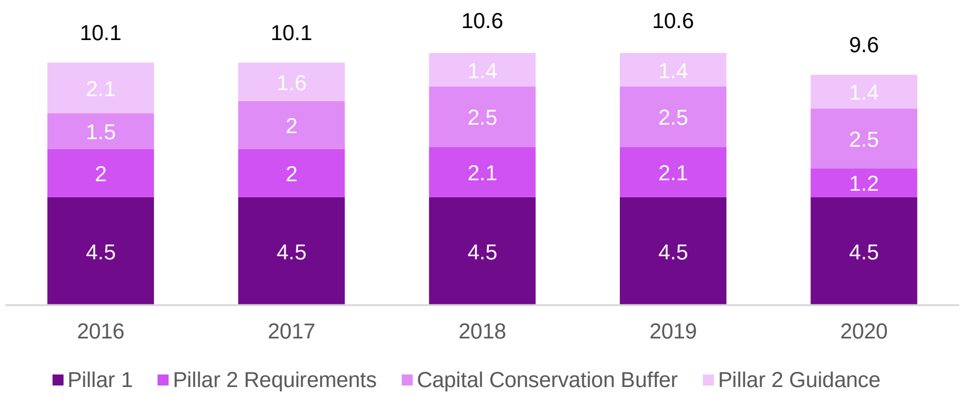


***Figure 2**: SREP requirements and guidance (excluding systemic buffers and countercyclical capital buffer) in CET1*



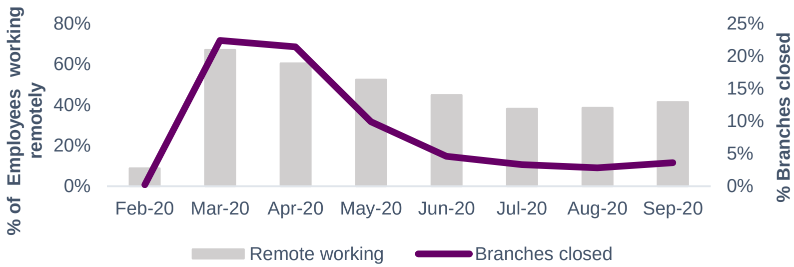
Euro area banks entered 2020 with significantly higher capital levels and far greater resilience to withstand the changing landscape than was the case at the time of the Great Financial Crisis (GFC) 2008. In August 2020, the CET1 ratio of institutions directly supervised by the ECB stood at 14.9%.

The evolution of LCR shows how banks are holding greater liquidity to minimise the impact of the current economic crisis.

Covid-19 impacts

In 2020, Covid-19 caused the greatest impact on the real economy and resilience of European banks. The outbreak of the pandemic and subsequent lockdown measures have resulted in an extraordinary economic shock, causing a significant drop in GDP projections and has led to several other Covid-19 induced uncertainties. Despite the severe lockdowns, banks across Europe were able to ensure business continuity with limited disruptions.

***Figure 5**: Percentage of Bank employees working remotely and the percentage of branches closed*

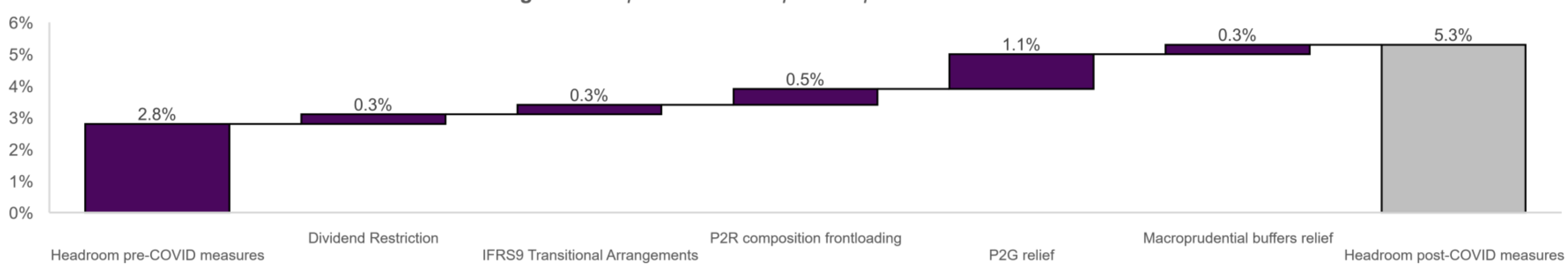


During March 2020, when most of the EU countries enforced severe lockdowns, the number of bank branches closed for public operations rose to around 22.4% resulting in around 66% of bank employees to work remotely. The number of branches closed and employees working remotely has since reduced.

Relief measures and recommendations to Eurozone banks:

1) **Temporarily operate below P2G, CCB and LCR limits**
2) **Use capital instruments that do not qualify as CET1 capital to meet P2R**
3) **Frontloading the new rules originally scheduled to come into force with CRD V**
4) **Flexibility in prudential treatment of loans backed by public support measures**
5) **Extending the deadline for complying with the SREP 2019 measures**
6) **Recommending banks not to pay dividends or conduct share buy-backs**

***Figure 6:** Capital Headroom pre and post Covid-19 crisis*



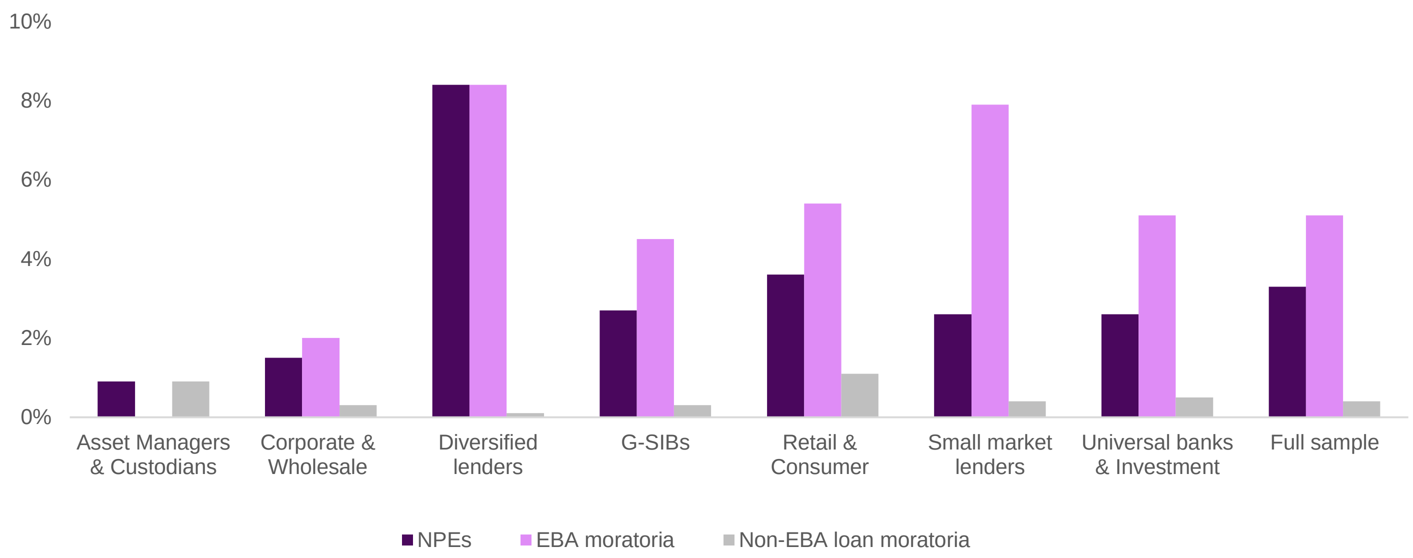
Taken together, these measures have almost doubled banks' capital headroom, from 2.8% to 5.3% as of the third quarter of 2020.

Covid-19 impacts – Loan moratoria

To minimise the medium and long term economic impacts of Covid-19 pandemic, EU Member States implemented a broad range of support measures. These measures included, in many instances, some forms of a moratorium on payments of credit obligations, to support the short-term operational and liquidity challenges faced by the borrowers.

Whilst the EBA is supportive of the measures and initiatives that were taken to address the economic consequences of the pandemic, it is also aware of the need to ensure that the risks are identified and measured accurately and promptly. Therefore, institutions must continue to identify obligors that may face longer-term financial distress and to classify them per existing regulations. This is crucial to evaluate the true quality of banks' portfolios and to ensure that institutions are adequately capitalised.

***Figure 7**: Total loans under moratoria with a breakdown by business model*



The proportion of loans with non-EBA moratoria is currently rather low, representing less than 1% of total loans. These loans do not meet the criteria for EBA moratoria and should be at least earmarked for forbearance to put them under enhanced monitoring, facilitating the identification of longer-term deterioration at an early stage.

In SREP 2020, diversified lenders reported the highest incidence of loans under the EBA loan moratoria and Non-Performing Exposures (NPEs) at 8.4%. The banks with the highest incidence of NPEs and loans under moratoria over total loans were all subject to dedicated recommendations by the EBA.

Covid-19 impacts – Digitalisation and operational cost

The pandemic has also resulted in banks scrambling to reduce their operational costs by investing in several IT projects and to fend off the threat of new challenger banks. This has led to increased investment by banks in IT projects and a continued decrease in their full-time employees (FTEs) and branches as part of this strategy.

Figure 8*: Distribution of IT costs as a percentage of total operating income by different business models*

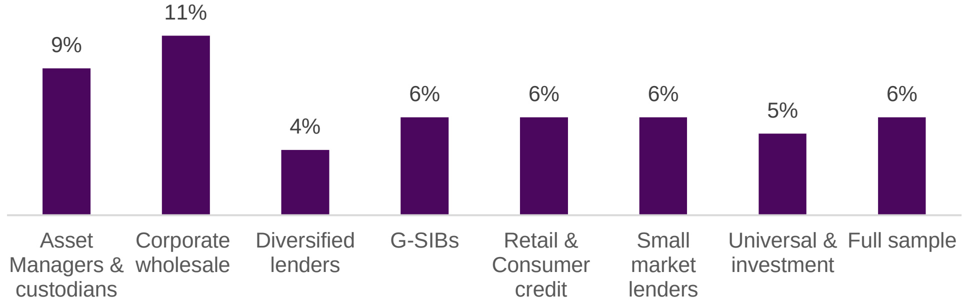
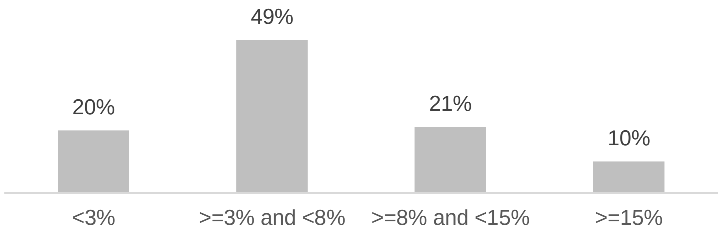


Figure 9*: Distribution of IT costs for significant banks as a share of Total Operating Income*

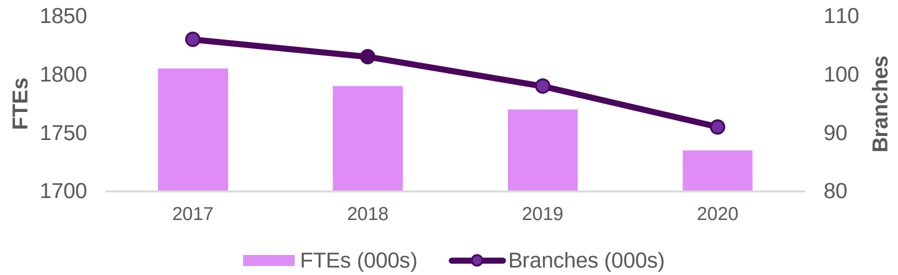


Corporate and wholesale lenders, custodians and asset managers spent the highest average share of their operating income on IT costs, whilst diversified lenders, universal and investment banks have the lowest average share.

In the UK, HSBC has decided to close over 82 branches between April and September as more customers have turned to digital banking.

Jackie Uhi, HSBC UK's head of the network, said: *"The Covid-19 pandemic has emphasised the need for the changes that we are making. It hasn't pushed us in a different direction but reinforces the things that we were focusing on before and has crystallised our thinking. This is a strategic direction that we need to take to have a branch network fit for the future."*

Figure 10*: Evolution of branches and FTEs from 2017 to 2020*



As the number of customers using physical branches continues to fall and the demand for digital services increases due to Covid-19, banks around Europe and across the world are constantly adapting their digital strategy. This has led to a reduction in the total FTEs and branches which has also reflected in a reduction of their operating expenses.

APPENDIX

Supervisory priorities for 2021

In 2021, the ECB will prioritise the following four areas that have been affected by the Covid-19 pandemic, to keep banks safe and sound:

01 Credit Risk Management

The focus will be on:

- **Initiatives that ensure banks have adequate risk management practices in place to identify, measure and mitigate the impact of credit risk,** as well as the operational capacity to manage the expected increase in distressed borrowers.
- **Adequacy of banks' credit risk management, operations, monitoring and reporting**. Particular emphasis will be placed on banks' capacity to identify any deterioration in asset quality and make timely and adequate provisions accordingly.

02 Capital Strength

The objective is to ensure:

- **Banks' capital positions are strong enough to absorb the increasing credit losses**, considering that the enhanced level of credit risk may impair banks' capital ratios.
- **Banks follow sound capital planning practices** based on capital projections that can adapt to a rapidly changing environment, particularly in a crisis.

03 Business Model Sustainability

Regarding this area:

- **Banking sectors already suffer from excess capacity, low-cost efficiency, low-interest rates and competition from other financial service providers.** This impact has been further stressed due to the Covid-19 pandemic.
- ECB will **focus on challenge banks' strategic plans.**

04 Governance

The focus will be on:

- **Sound governance practices and robust internal controls,** that are crucial for mitigating risks such as misconduct, money laundering, cybercrimes and IT failings
- Adequacy of the **banks' crisis risk management framework**
- Assessment of the **prudential impact of money laundering and terrorism financing risks.**

How can Reply assist?

Risk, Finance & Compliance

We partner with our clients to address the practical implications of risk, finance and compliance-related challenges. We focus on identifying opportunities to improve business insight and reduce costs, with deep experience in programme and transformation delivery.

Quantitative Risk Management

We support our clients across the model life-cycle, from development through to measurement and validation of model risk. Our teams specialise in all relevant model types – including risk, capital, liquidity, pricing, and stress testing models.

Data Management and Implementations

We help our clients to design, develop and implement innovative and efficient technology enabled solutions in areas of data management and governance, process automation and regulatory reporting.

Regulatory Engagement

We support our clients in effectively managing their regulatory relationships and in obtaining relevant regulatory permissions and authorisations. We help our clients navigate the complex regulatory landscape to achieve optimal outcomes.

Automation and AI

Cloud Implementation

Our people

Vishwas Khanna, Partner

Vishwas specialises in prudential regulation, risk transformations, programme leadership and new bank authorisations. He is a trusted advisor to the C-Suite and senior management at banks and offers objective, independent advice to his clients to influence strategic decision-making.

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