EUROPEAN CENTRAL BANK

BANKING SUPERVISION

Press release

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ECB keeps capital requirements steady in 2023, as banks remain resilient

- SREP results show banks have solid capital and liquidity positions and increased profitability, with scores broadly unchanged
- CET1: weighted average of Pillar 2 requirements set at 1.1%, unchanged from last year
- CET1: weighted average of overall capital requirements and guidance in CET1 rise to 10.7%, up from 10.4%, reflecting impact of macroprudential policies
- Credit risk and internal governance remain key areas for supervisory action

The European Central Bank (ECB) today published the results of its Supervisory Review and Evaluation Process (SREP) for 2022. This process provides an overall assessment of the challenges facing significant institutions, together with the corresponding capital requirements and other supervisory measures that banks are expected to comply with for the year ahead, in order to better face these challenges.

The SREP was conducted amid deteriorating economic conditions and financial market dynamics following Russia's invasion of Ukraine. Despite the outlook worsening throughout the year, rising interest rates led to improved profitability and capital generation. On average, banks maintained solid capital and liquidity positions, with the vast majority holding more capital than the levels dictated by capital requirements and guidance stemming from the previous SREP cycle. SREP scores have also remained broadly unchanged overall.

"Banks have done well in withstanding the economic impact of the Russian invasion of Ukraine, thanks to their strong capital and liquidity positions, increased profitability and continued improvement in asset quality," said Andrea Enria, Chair of the ECB's Supervisory Board. "However, challenges will remain as long as the war drags on, and the effects of rising interest rates warrant careful monitoring. Banks need to address persistent weaknesses, particularly in their risk control and governance frameworks, and to assess future developments in a prudent way".

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The ECB introduced a number of initiatives in 2022 aimed at fostering banks' response to medium-term structural transformations, such as the digitalisation of the financial system and the transition to a green economy. These initiatives were designed to incorporate the thematic review on climate-related and environmental risk and climate stress test results in the SREP. The ECB also launched a knowledge-gathering project across the banking sector to monitor the adoption of digital transformation and the adaptation of business models.

For the year ahead, the weighted average of Pillar 2 requirements (P2R) set by the ECB for total capital remained in line with the requirements set out in previous years, at 2.0% of risk-weighted assets (RWA) after 1.9% in 2022.

The P2R for CET1 also remained broadly unchanged for 2023, at 1.1%.

Given that no SSM-wide capital stress test was performed in 2022, Pillar 2 guidance (P2G) remained largely unchanged at an average of 1.3%.

The 2022 SREP resulted in P2R add-ons for non-performing exposures for 24 banks that fell short of ECB coverage expectations related to non-performing loans (NPLs) granted before 26 April 2019. Institutions have been encouraged to close these gaps. The aggregate shortfall in NPL provisions amounted to 7 basis points of RWA at the end of the SREP cycle. Banks that actively address the shortfall in their coverage compared with ECB expectations will be able to swiftly reduce the new add-on in the course of 2023, without having to wait for the next SREP assessment.

A capital add-on was also included in the P2R for a few banks with very high exposures to leveraged transactions or highly deficient risk controls in this line of business.

For the first time, the ECB assessed the risk of excessive leverage in a SREP exercise. The aim was to identify banks that need to apply qualitative measures or P2R for the leverage ratio. The ECB issued qualitative measures for four banks as a result.

For the period ahead, the overall capital requirements and guidance have been increased, on average, to 15.0% of RWA, from 14.7% in the previous SREP cycle.

The average amount of overall capital requirements and guidance in CET1 increased to around 10.7% of RWA for 2023, up from 10.4% in 2022. At the end of the third quarter of 2022, the average amount of CET1 held by significant institutions totalled 14.7% of RWA.

The increase in overall capital requirements and guidance mostly reflects the impact of macroprudential policies set by national competent authorities. During 2022 several announced increases in countercyclical capital buffers and systemic risk buffers, applicable from the start of 2023,

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taking the average combined buffer requirement from 3.6% of RWA in the first quarter of 2022 to 3.8% of RWA in the first quarter of 2023.

The average overall SREP score in 2022 was broadly unchanged, with 92% of the banks covered receiving the same overall SREP score as in 2021.Half of the remaining 8% saw their score worsen.

The ECB imposed qualitative measures primarily in the areas of internal governance and credit risk. This is where supervisors looked at the broader quality of banks' internal risk control frameworks and the effectiveness of banks' management bodies, in line with the supervisory priorities set for the years 2022-24.

Findings on internal governance highlighted concerns about the effectiveness and composition of management bodies, their collective suitability and their oversight role. The main concerns in the area of risk management related to the fact that banks lack clarity about their risk appetite and have inadequate practices to assess and manage climate-related and environmental risk.

The ECB also found that many banks had insufficient resources across all their control functions (risk management, compliance and internal audit). At the same time, many banks had failed to sufficiently improve their capabilities in risk data aggregation and reporting. This in turn had a negative effect on data quality and the banks' ability to produce non-standardised reports. Many IT landscapes continued to be fragmented and not harmonised, which impeded data aggregation and reporting.

The war in Ukraine had also led to an increase in operational and IT/cyber-related risks, pushing banks to tackle deficiencies in their outsourcing arrangements and in their IT security and cyber resilience frameworks.

Despite the continued reduction of NPLs, the credit risk scores of more than half of the banks involved were unchanged. Signs of latent credit risk emerged, with Stage 2 ratios and forbearance remaining above pre-pandemic levels, while Stage 2 coverage dropped below pre-pandemic levels for many banks. In 2022 scores were still underpinned by persisting risk control deficiencies, particularly in the area of loan classification and in the implementation of the EBA's Guidelines on loan origination and monitoring.

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Notes

- **The** SREP **is an annual exercise** in which supervisors examine banks' risks and produce capital requirements and guidance for each individual bank (which is in addition to legally required minimum capital). The SREP assesses four main elements: the viability and sustainability of business models, the adequacy of internal governance and risk management,

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risks to capital and risks to liquidity and funding. Each element is given a score ranging from 1 to 4 (with 1 being the best and 4 the worst). These scores are then combined to produce an overall score (which also ranges from 1 to 4).

- The 2022 SREP assessment cycle was generally based on year-end data for 2021. The decisions resulting from the 2022 SREP assessment are applicable in 2023.
- **Combined buffer requirements** comprise the capital conservation buffer, the countercyclical capital buffer and systemic buffers (whereby systemic buffers comprise buffers for global systemically important institutions, other systemically important institutions and systemic risk), which are legal requirements established by the EU's Capital Requirements Directive (CRD IV) or by national authorities.
- The capital that banks are expected to maintain as a result of the SREP consists of two parts. The first is **the Pillar 2 requirement (P2R)**, which covers risks that are underestimated or not covered by Pillar 1. The second is **the Pillar 2 guidance (P2G)**, which indicates the level of capital that a bank should maintain in order to have a buffer sufficient to withstand stressed conditions (as assessed, in particular, on the basis of the adverse scenario in the supervisory stress tests). While the P2R is binding and breaches can have direct legal consequences for banks, the P2G is not binding.
- **Overall capital requirements and guidance** means Pillar 1 + Pillar 2 requirement + combined buffer requirement + Pillar 2 guidance. See the Supervisory Methodology for additional information on the composition of the capital stack. All figures are reported as percentages of risk-weighted assets.
- **Stage 2 loans** include assets that have seen a significant increase in credit risk since initial recognition.

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