EUROPEAN CENTRAL BANK

BANKING SUPERVISION

Press release

28 January 2020

ECB keeps capital requirements and guidance for banks stable and increases transparency

- Overall SREP requirements and guidance for CET1 capital in 2019 unchanged from 2018, at 10.6%
- In move to increase transparency, ECB publishes bank-specific data
- Business model risk remains key area of concern owing to low profitability
- Internal governance continues to show signs of deterioration

The European Central Bank (ECB) today published the outcomes of its 2019 Supervisory Review and Evaluation Process (SREP). The overall SREP requirements and guidance for Common Equity Tier 1 (CET1) capital remained stable at 10.6% in 2019, the same level as in 2018. CET1 is a bank’s highest-quality capital, consisting largely of common stock. The average Pillar 2 requirement, set by the supervisor for each bank, stood at 2.1% and the non-binding Pillar 2 guidance at 1.5%, both unchanged from the previous year.

The SREP is an annual exercise in which the supervisor examines banks’ risks and subsequently determines individual capital requirements and guidance for each bank, in addition to legally required minimum capital.

For the first time the ECB is also publishing aggregate data by business model and bank-by-bank information on Pillar 2 requirements in an effort to improve transparency. For this SREP cycle, 108 banks agreed to this disclosure or have already published the Pillar 2 requirements on their own websites.

“We are broadly satisfied with the overall level of capital adequacy of the significant institutions under our supervision,” Andrea Enria, Chair of the ECB Supervisory Board, said. “Our assessment highlighted remaining concerns, in particular when it comes to the business models, internal

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governance and operational risks in banks. This is where we will sharpen the focus of our supervisory work."

The overall CET1 levels requested by authorities, including the systemic and countercyclical buffers, which are not set by ECB Banking Supervision, rose by 20 basis points to 11.7%. This was due to a 10 basis point increase in the countercyclical buffer and a 10 basis point increase in the systemic buffers.

Most significant institutions have CET1 levels above the overall capital requirements and guidance. Six out of the 109 banks that participated in the 2019 SREP cycle showed CET1 levels below the Pillar 2 guidance. For those banks which have not taken satisfactory measures in the last quarter of 2019, remedial actions have been requested within a precise timeline.

The SREP assesses four main elements: the viability and sustainability of business models, the adequacy of internal governance and risk management, the risks to capital (with its sub-components of credit risk, market risk, interest rate risk in the banking book and operational risk) and the risks to liquidity and funding. The assessment of each element leads to an element-specific score from 1 to 4 (1 being the best score, 4 the worst) for every bank which is then combined into an overall score from 1 to 4, in line with the European Banking Authority guidelines on SREP.

The share of banks receiving an overall score of 3 increased to 43% in 2019 from 38% in 2018. Meanwhile the share of banks classified as worst performers, scoring 4, decreased to 8% from 10%. At the same time the percentage of banks that scored 2 decreased to 49%, from 52%. No significant bank scored 1.

There are three areas of notable deterioration in the SREP scores:

- An assessment of business models showed that most significant institutions' earnings are below their cost of capital. This hampers their capacity to organically generate capital and to issue new equity. Concerned by low profitability, supervisors are increasingly focusing on banks' future resilience and the sustainability of their business models.
- Internal governance is proving to be an area for supervisory concern: governance scores have worsened overall over recent years. Three out of four banks (76%, up from 67% in 2018) scored 3. Only 18% of banks achieved a score of 2, down from 25% in 2018. Findings show that in a significant number of instances management bodies are not effective and internal controls are weak.
- Furthermore, some banks reported material losses which were mostly due to conduct risk events. This is reflected in the growing number of banks that scored 3 for operational risk: 77%, up from 63% in 2018. IT/cyber risks have also been a key source of operational risk.

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In response to the deterioration in scores, 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.

This SREP cycle highlighted that the banks with high levels of non-performing loans (NPLs) are broadly meeting the targets for cleaning their balance sheets. These banks are recommended to keep a strong focus on continuing to improve their credit risk profiles.

When the ECB assumed its supervisory responsibilities five years ago, the volume of NPLs held by significant institutions stood at around €1 trillion (an NPL ratio of 8%). By the end of September 2019, it had been reduced to €543 billion (an NPL ratio of 3.4%).

Regarding risks to liquidity, overall scores showed that banks had a good liquidity position. In this category, 76% of banks had a score of 2 (70% in 2018) and only 4 banks scored 1 (down from 12 in 2018). Many significant institutions have missed their own funding plan targets for 2018, also due to their changed expectations of monetary conditions.

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Notes

- The **2019 SREP assessment cycle** is generally based on year-end data for 2018. The decisions resulting from the 2019 SREP assessment are applicable in 2020.
- The **capital conservation buffer**, the **countercyclical buffer and the systemic buffers** (systemic buffers include buffers for global systemically important institutions or G-SIIs and other systemically important institutions or O-SIIs and systemic risk) are legal requirements established either by the EU Capital Requirements Directive (CRD IV) or set by the national authorities.
- The capital demand resulting from the SREP consists of two parts. One is the **Pillar 2 requirement or P2R**, which covers risks underestimated or not covered by Pillar 1. The other is the **Pillar 2 guidance or P2G**, which indicates to banks the adequate level of capital to be maintained in order to have sufficient capital as a buffer to withstand stressed situations, in particular as assessed 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. Nevertheless, ECB Banking Supervision certainly expects banks to follow P2G.

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