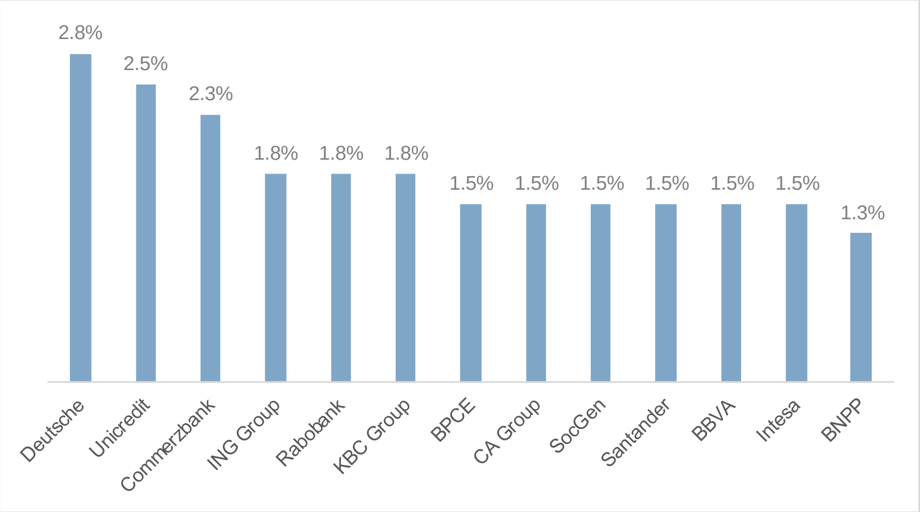
Understanding SREP and What it Means for Capital Requirements

Under the Single Supervisory Mechanism (SSM), the largest euro area (EA) banks would have received their Supervisory Review and Evaluation Process (SREP) decisions for 2017. This is only the second time that a common approach has been applied across the EA. As shown below, the levels of additional own funds requirements (Pillar 2) stemming from the 2016 exercise appear more coherent than previously.

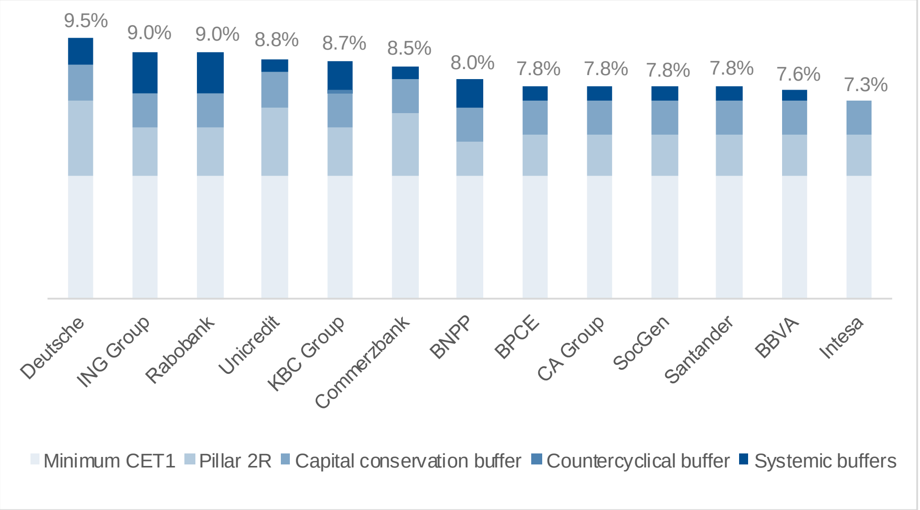
Figure 1: Pillar 2 requirements for 2017



Source: Company data, Scope Ratings

In this year's SREP decisions, a portion of Pillar 2 requirements (Pillar 2R) was shifted to Pillar 2 guidance (Pillar 2G), meaning that the MDA threshold has decreased from an average of 10.2% to 8.3%. The ECB also updated its recommendations and guidelines on dividend distributions and remunerations policies. These two developments further clarify when banks may be limited in their ability to pay dividends and AT1 coupons. Meanwhile, Scope continues to point out that the levels of capital banks are expected to maintain can still vary meaningfully due to national discretion over systemic buffers, particularly for those banks which are not systemically important globally.

Figure 2: SREP CET1 demand for 2017



Source: Company data, Scope Ratings

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SREP: What is it?

An assessment of risks…

According to the ECB, the SREP summarises the supervisor's assessment and findings in a given year and sets objectives for the bank to achieve within a specific time to address identified issues. The process is meant to be holistic, with a bank's risk profile being examined through four specific areas:

- **Business model**: an assessment of the viability (within one year) and sustainability of the business (three years and beyond).
- **Governance and risk management**: includes assessments of the internal governance framework (including key control functions such as risk management, internal audit and compliance), risk culture, risk infrastructure and remuneration policies and practices.
- **Risks to capital** assessed from three perspectives. The supervisory perspective encompasses four risk categories: credit risk, market risk, operational risk and interest rate risk in the banking book. The bank's perspective includes an evaluation of the reliability of the Internal Capital Adequacy Process (ICAAP). Lastly, the forward-looking perspective relies on bank internal stress tests and supervisory stress tests.
- **Risks to liquidity and funding** assessed from three perspectives. The supervisory perspective encompasses short-term liquidity and funding sustainability. The bank's perspective includes an evaluation of the Internal Liquidity Adequacy Process (ILAAP). The forward-looking perspective relies on bank internal stress tests and supervisory stress tests.

A score is assigned to each of the above factors (on a scale from one to four, with one being the best score). The assessment involves three phases: (1) data gathering, (2) an automated anchoring score and then (3) supervisory judgement to determine the final score. Based on supervisory judgement, the phase two score can be improved by one notch or lowered by up to two notches.

… plus detailed measures for addressing concerns

Following this four-area examination, a bank is assigned an overall SREP score on the same one to four scale. The overall score is the basis for assessing capital and liquidity adequacy and for taking any necessary supervisory measures to address concerns. The joint supervisory teams prepare individual SREP decisions for each bank with specific measures to be implemented.

SREP decisions may include own fund requirements, quantitative liquidity requirements and other qualitative measures. As the risk profile of a bank increases, the likelihood of supervisors imposing qualitative measures rises. Own fund requirements may be comprised of total SREP capital requirements (8% minimum (of which 4.5% CET1, 6% Tier 1) plus any Pillar 2R), combined buffer requirements and a recommendation to "follow a linear path towards fully loaded ratios". SREP decisions from the 2016 exercise also included a Pillar 2G component, which is not considered a requirement. The quantitative impact of the ECB's 2016 adverse stress test was one consideration for determining the level of Pillar 2G.

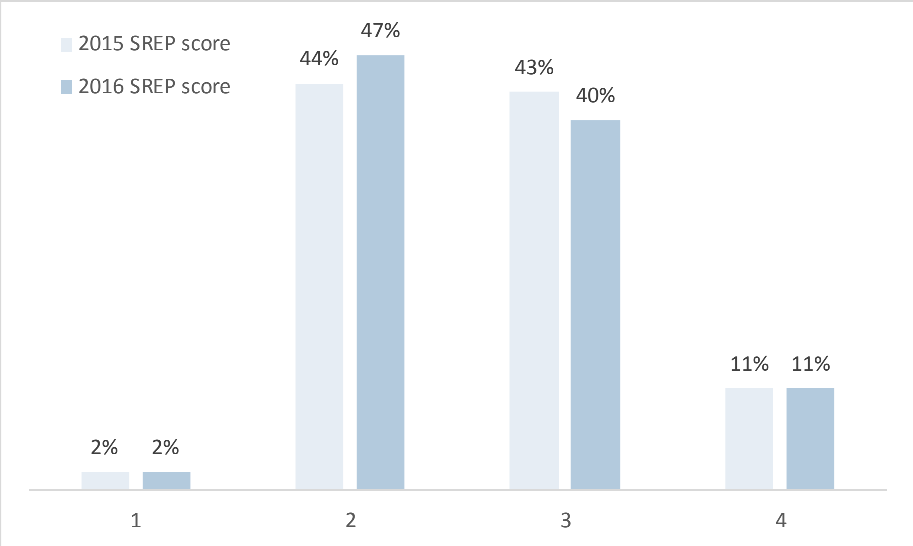
In regards to liquidity requirements, a bank may be asked to maintain a liquidity coverage ratio (LCR) higher than the regulatory minimum or sustain a higher survival period. Examples of other SREP-related supervisory measures include removing members of management, requiring additional disclosures, restricting or prohibiting distributions to shareholders and, if necessary to AT1 investors, and restricting or limiting business activities to reduce excessive risks.

Results of 2016 SREP exercise

Distribution of overall SREP scores broadly stable

In 2016, the SSM performed the SREP exercise for the second time on over 120 significant institutions in 19 countries. The distribution of overall SREP scores appears relatively stable compared to 2015, although the ECB stated that there were some idiosyncratic changes. We presume that the banks with the highest risk profiles are those which performed less well in the various EBA/ECB stress tests and transparency exercises. As shown below, the majority of banks have SREP scores of two or three.

Figure 3: Distribution of overall SREP scores (2015 vs 2016)



Source: ECB, Scope Ratings

Higher risk profile results in higher capital demand

Interestingly, the ECB has also provided the SREP CET1 demand by overall SREP score which shows that as a bank's risk profile increases so does the level of CET1 required by the supervisor.

Figure 4: CET1 demand by overall SREP score

Note: Excludes systemic buffers (G-SII, O-SII and systemic risk buffer).
Source: ECB, Scope Ratings

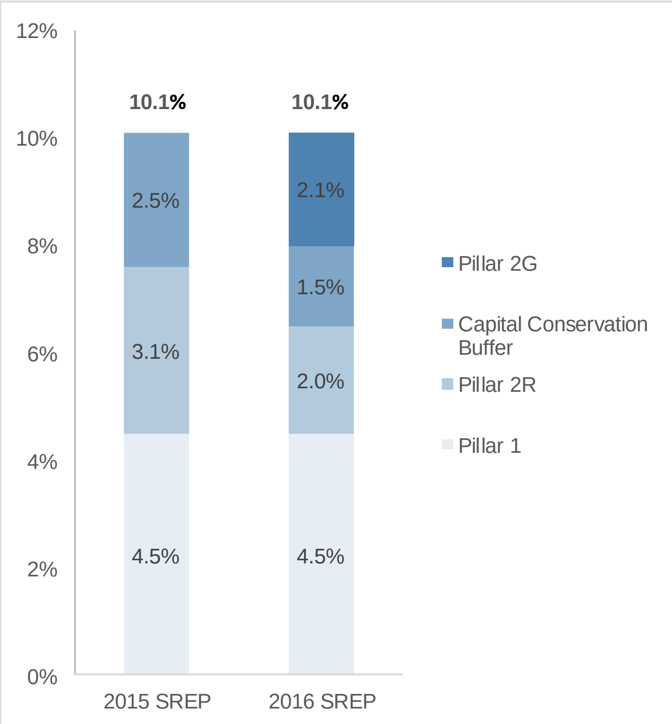
Overall CET1 demand consistent even with Pillar 2G

Capital requirements stemming from the 2015 SREP exercise were not entirely transparent and caused confusion amongst investors. For the 2016 SREP exercise, communication regarding Pillar 2 requirements was much improved and the concept of Pillar 2G was introduced. Figure 5 shows that on average the overall CET1 demand did not change from 2015 to 2016 when Pillar 2G is added. Consequently, we have not seen banks adjusting their capital targets.

Nonetheless, the introduction of Pillar 2G is a positive development for AT1 investors as it reduces Pillar 2R and thus the MDA threshold. According to the ECB, the MDA trigger level decreased from an average of 10.2% to 8.3% because of the shift of capital from Pillar 2 in 2015 to Pillar 2G in 2016.

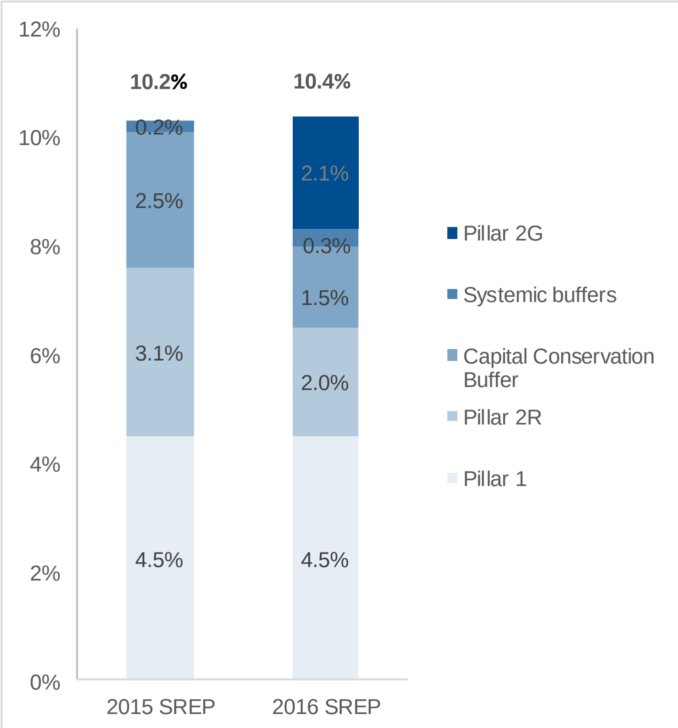
Figure 5: CET1 demand (2015 vs 2016)

CET1 demand (excluding systemic buffers)



Source: ECB, Scope Ratings

CET1 demand (including systemic buffers)



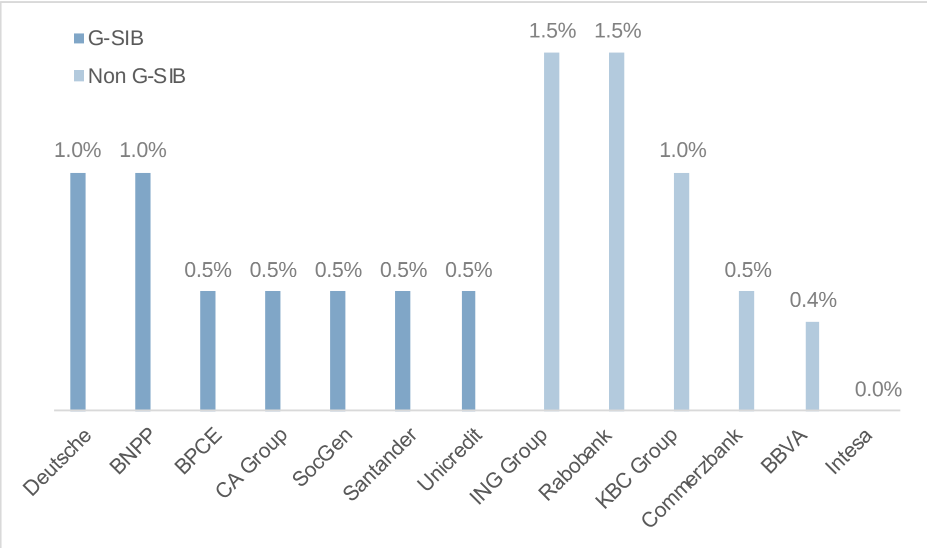
Source: ECB, Scope Ratings

Explaining the variation in SREP requirements

Based on information provided by the ECB, the correlation between overall SREP scores and capital requirements appears reasonable. However, when looking at individual bank SREP requirements, there can be significant differences driven by national discretion over systemic buffers – in particular, other systemically important institution (O-SII) buffers and systemic risk buffers. While stemming from economic conditions and a bank's geographical exposure, countercyclical buffers can also contribute to the variation in capital requirements.

As already highlighted by Scope in our piece on *Understanding the role of capital buffers*, national authorities determine which institutions are O-SIIs and then can require an additional O-SII buffer ranging from 0% to 2%. Further, national authorities can set a systemic risk buffer ranging from 1% to 5%. Systemic risk buffers can apply to all institutions, or to a subset of institutions with similar risk profiles in their business activities. While they may be justified, this means that across Europe we see banks subject to systemic buffers ranging from less than 1% up to 5%. As well, the implementation period for systemic buffers can vary; some must be met immediately with no phase-in period while some may be phased-in until 2018, 2019 or 2021.

Figure 6: Systemic buffers for 2017



Source: Company data, Scope Ratings

Banks expected to be prudent in regards to distributions

Improving transparency, the ECB in December 2016 updated its Recommendation on Dividend Distribution Policies and Key Principles on Remuneration Policy. In regards to the distribution of dividends, the guiding principles are “in a conservative manner” and to the extent that a “linear path towards required fully loaded capital requirements and Pillar 2G is ensured”. While not relevant for the MDA threshold, banks are expected to meet Pillar 2G and if a bank does not or expects not to it should contact the supervisor immediately.

More specifically, in regards to banks paying dividends in 2017 for the financial year 2016, the ECB makes the following recommendations:

- A bank that already meets fully loaded capital requirements (Pillar 1, Pillar 2R and combined buffer requirements) should distribute dividends in a manner such that they continue to fulfill all requirements and outcomes of the SREP even if economic and financial conditions deteriorate.
- A bank that meets applicable capital requirements but has not reached fully loaded ratios should distribute dividends in the same manner as above; but in addition should only pay out dividends such that at a minimum a linear path to required fully loaded capital requirements is secured.
- A bank which does not meet capital requirements should in principle not distribute dividends.

As with the distribution of dividends, banks’ remuneration policies should be consistent with a “conservative” and a linear path towards meeting fully loaded capital requirements and Pillar 2G.

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