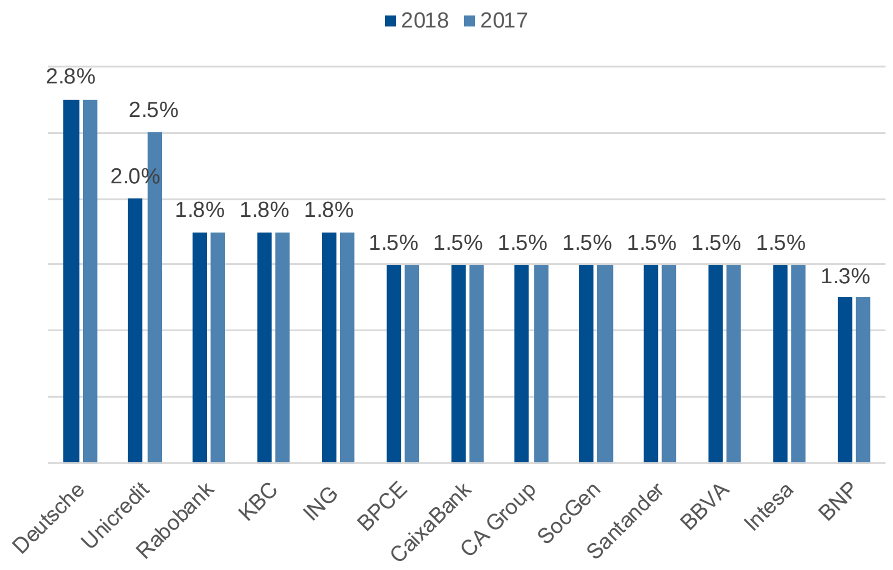
SREP Capital Requirements
Further Consistency and Improvement in Risk

Last year, under the Single Supervisory Mechanism (SSM), significant institutions in 19 European countries underwent the Supervisory Review and Evaluation Process (SREP) for the third time based on a common approach. From the disclosures of several of the largest euro area (EA) banks, we note positively the relative stability and consistency in SREP-driven capital requirements.

The bank-specific component of SREP capital is the Pillar 2 requirement (P2R), as the Pillar 1 minimum and the capital conservation buffer are the same for all banks. Pillar 2 guidance (P2G) is also bank-specific but this is rarely disclosed. According to the ECB, the average P2G for EA banks is 1.6% for 2018, down from 2.1% for 2017, with the decline appearing to coincide with the increase in the capital conservation buffer to 2%, from 1.5% for 2017. Meanwhile, the average P2R remains unchanged at 2%.

In Figure 1, we note the stability in P2R compared to last year. In our sample, Unicredit is the only bank to see a meaningful change, with its 2018 P2R dropping to 2% vs 2.5% in 2017, validating the progress the bank has made in de-risking its risk profile.

Figure 1: Pillar 2 requirements, 2018 vs 2017



Source: Company data, Scope Ratings

In addition to P2R, capital buffers (countercyclical and systemic) further determine the level of CET1 capital that a bank must maintain. The countercyclical buffer is calculated as the weighted average of the buffers in effect in the jurisdictions to which a bank has credit exposure. While many countries in Europe still have a countercyclical buffer set at 0%, there are higher levels in countries such as Norway, Sweden, Slovakia and the UK, and this is starting to materialise in additional requirements for some banks.

Regarding G-SIBs, BNP saw its buffer drop to 1.5% from 2%, while BPCE is no longer considered by the FSB to be globally systemically important. Meanwhile, systemic buffers set nationally range from 0.25% to 3%. The Netherlands continues to stand out, requiring its largest banks to have a 3% systemic risk buffer.

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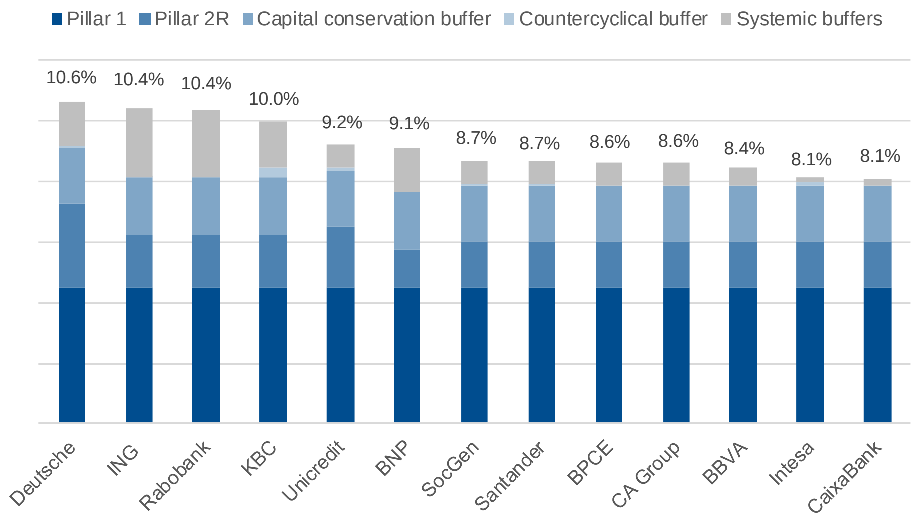
Figure 2: SREP CET1 demand for 2018 (including buffers)



Source: Company data, Scope Ratings

Results of 2017 SREP exercise

The SREP summarises the supervisor's assessment in a given year and sets objectives for a bank to achieve within a specific time to address identified concerns. Four areas of a bank's risk profile are examined: business model, governance and risk management, capital, and liquidity and funding. Each of the elements is assigned a score on a scale from one to four, with one being the best score. As well, each bank is assigned an overall SREP score using the same one-to-four scale.

In its December 2017 presentation on the 2017 SREP exercise, the ECB stated that risks were "fairly stable" compared to last year, but profitability and the high level of NPLs were issues. The assessment and stress testing of interest rate risk in the banking book (IRRBB) was incorporated in the analysis of risks to capital. Further, the quantitative impact of interest rate risk on the Economic Value of Equity informed the calibration of P2G. Next year's P2G will be informed by the results of the upcoming EBA stress test exercise.

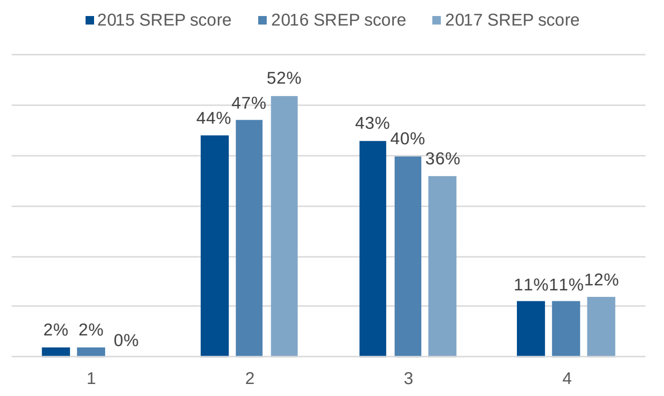
An indication of the improving risk profile of banks

Most banks have an overall SREP score of two or three. More interesting, however, is the shift in distribution over the last three years – the proportion of banks with an overall SREP score of two has increased while the proportion with an overall SREP score of three has decreased – indicating an improvement in the risk profile of banks (Figure 3).

Notwithstanding improving SREP scores, we do not foresee a material change in SREP capital demands in the near future for two reasons: (1) the level required includes the capital conservation buffer which will phase-in to 2.5% in 2019 and (2) the ECB has communicated that "all other things being equal, the capital demand can be expected to remain broadly stable".[1] The average overall SREP CET1 capital demand, excluding systemic buffers, is unchanged from the previous year at 10.1%.

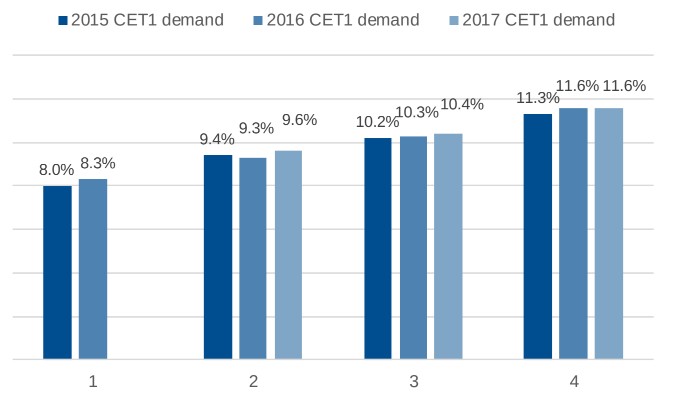
[1] SSM SREP Methodology Booklet, 2017 edition, p.40.

Figure 3: Distribution of overall SREP scores



Source: ECB, Scope Ratings

Figure 4: CET1 demand by overall SREP score



Notes: Excludes systemic buffers (G-SII, O-SII and systemic). No institution had an overall SREP score of one for 2017.
Source: ECB, Scope Ratings

Consistency in regulatory capital demands

As shown in Figure 4, the average CET1 demand by overall SREP score has been quite consistent, with the supervisor requiring more capital, the higher the SREP score (i.e. the higher the risk profile). The ECB further disclosed that 39 banks have been assigned liquidity-related measures (primarily qualitative) and 84 banks have been assigned other qualitative measures – particularly those banks with a SREP score of four. The qualitative measures cover a wide range of weaknesses such as NPLs, internal governance, data quality and operation risk.

Future supervisory priorities are wide-ranging

Supervisors will be focused on the following areas in 2018, with some issues being under attention for the next few years:

- Implications of interest rate risk for banks' business models and profitability,
- Consistent approach to NPLs/forborne exposures,
- Exposure concentrations and collateral management and valuation (e.g. real estate),
- TRIM – credit risk, market risk, and counterparty credit risk models,
- Improving banks' internal capital adequacy assessment process (ICAAP) and internal liquidity adequacy assessment process (ILAAP) approaches,
- Evaluating preparedness for IFRS 9 and other regulatory changes, and
- Brexit preparations.

Message of prudence regarding distributions reiterated

In December 2016, the ECB updated its Recommendations on Dividend Distribution Policies and Key Principles on Remuneration Policy. These were again repeated in December 2017, with the guiding principles being "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 (particularly pertinent for AT1 investors), banks are expected to meet Pillar 2G and if a bank does not or expects not to it should contact the supervisor immediately. Consequently, we have not seen banks lowering their capital targets despite the separation of Pillar 2 into P2R and P2G components.

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