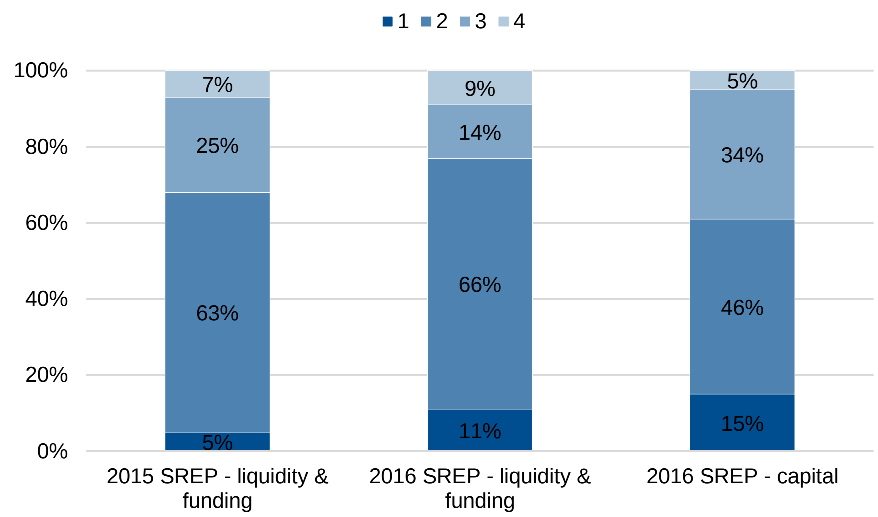
Understanding SREP and What It Means for Liquidity Requirements

The Supervisory Review and Evaluation Process (SREP) has been in place long enough for analysts and investors to understand that the supervisory process has implications for the capital requirements of European banks. What may be less understood is that SREP also has implications for liquidity requirements. We expect further attention to this area as the ECB has proposed new guidance to enhance convergence between the assessment of capital and liquidity adequacy as well as greater harmonization across the Single Supervisory Mechanism (SSM).

In addition to a review of a bank's business model, governance and risk management, and risks to capital, the SREP evaluates risks to liquidity and funding. As seen below, there has been a reassuring improvement in scores; with 25% of banks being classified as having a liquidity position and/or funding profile which posed a medium or high level of risk to viability, down from 34% in 2015. Meanwhile, the proportion of banks whose quantity and composition of own funds was considered to pose a medium or high level of risk was 39%.

Figure 1: SREP scores for liquidity & funding and capital risks



Note: A score of 1 represents no discernible risk while a score of 4 represents high risk. 2016 figures based on banks with a final SREP 2016 decision as of 30 November 2016.
Source: SSM SREP Methodology Booklet 2016, Scope Ratings

When presenting the outcome of the 2016 SREP, the ECB highlighted that there were targeted liquidity measures to address main weaknesses such as an over-reliance on wholesale short-term funding, the need to adequately monitor and manage risks associated with collateral, especially availability and needs during stress, and the need to integrate liquidity risk within the overall risk appetite framework.

As well, quantitative measures available to address liquidity and funding risks include a higher liquidity coverage ratio (LCR) than the regulatory minimum, requiring a specific minimum survival period and requiring a minimum amount of liquid assets.

Analyst

Pauline Lambert
p.lambert@scoperatings.com

Investor Outreach

Michael Pinkus
m.pinkus@scoperatings.com

Scope Ratings AG

Suite 301
2 Angel Square
London EC1V 1NY

Phone +44 20 3457 0444

Headquarters

Lennéstraße 5
10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100
Service +49 30 27891 300

info@scoperatings.com
www.scoperatings.com

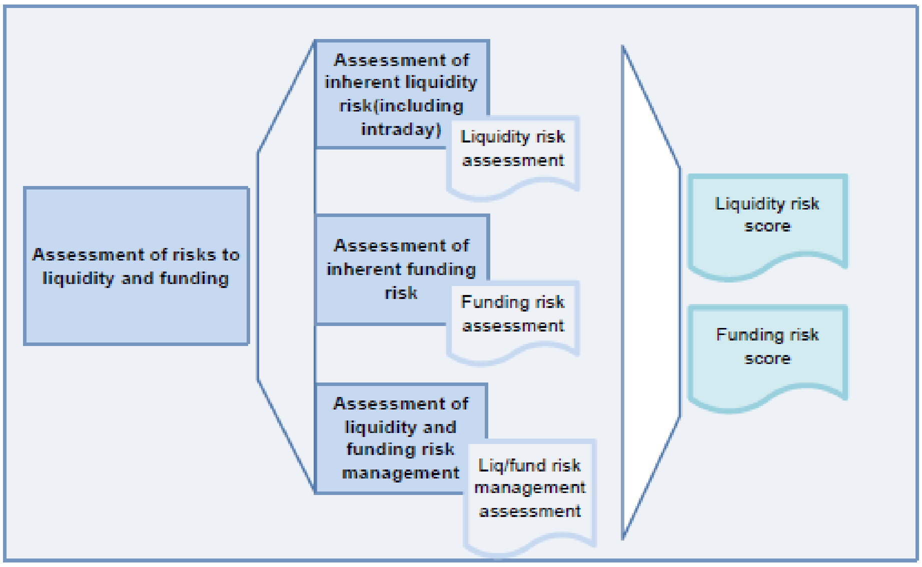
Bloomberg: SCOP

Risks to liquidity and funding; one of four SREP elements

The overall SREP assessment comprises a review of a bank's business model, governance and risk management, risks to capital and risks to liquidity and funding. While there is an overall SREP score, each of the elements is also scored along the same scale.

In December 2014, the EBA published detailed guidelines on common procedures and methodologies for SREP. After assessing the risks to liquidity and funding, competent authorities then need to determine whether the liquidity available provides sufficient coverage for the risks identified. This assessment is based on an institution's Internal Liquidity Adequacy Assessment Process (ILAAP); is it reliable, credible and understandable? Other relevant inputs include assessments of liquidity and funding risks, supervisory benchmarks, and peer group analysis.

Figure 2: Elements of assessing risks to liquidity and funding



Source: EBA

Determining whether liquidity is adequate

When assessing an institution's liquidity adequacy, factors considered by supervisors include:

- Risks not covered by liquidity requirements, such as intraday liquidity risk and liquidity risk beyond 30 days;
- Other risks not adequately covered or measured by the institution due to underestimating outflows, overestimating inflows, or overestimating the liquidity value of buffer assets;
- Concentrations in access to liquid assets and/or funding by counterparty and/or product type;
- Funding gaps in specific maturity buckets in the short, medium and long term;
- Appropriate coverage of funding gaps in different currencies; and
- Cliff effects.

Setting institution-specific requirements

As detailed in the EBA guidelines, if there is a need for specific quantitative liquidity requirements, competent authorities should use one of three approaches:

- Approach 1 – require a LCR higher than the regulatory minimum;
- Approach 2 – require a minimum survival period; competent authorities may require different types of liquid assets (e.g. assets eligible for central banks) to cover risks not (adequately) covered by the LCR; and
- Approach 3 – require a minimum total amount of liquid assets or access to liquid assets; competent authorities may set requirements for the composition of liquid assets.

The EU LCR Deregulated Regulation was adopted in October 2014, with the minimum requirement set at 60% from October 2015 and gradually increasing to 100% by January 2018. This is one year before the Basel standard.

Competent authorities may also require a minimum level of stable funding in terms of the net stable funding ratio (NSFR). In general, this ratio should be equal to or higher than 100% for EU banks from January 2018.

As well, qualitative requirements may be set in the form of restrictions/caps/limits on mismatches, concentrations and risk appetite. The higher a bank's risk profile, the greater the likelihood of qualitative requirements.

Push for greater convergence and harmonisation

Under Basel, banks are required to assess whether they have sufficient capital and liquidity to support current and future risks. The results of the Internal Capital Adequacy Assessment Process (ICAAP) and ILAAP which are prepared by the banks are reviewed by supervisors and are vital inputs for SREP.

In January 2016, the ECB published for the first time its expectations on ICAAP and ILAAP. After the 2016 SREP, the ECB highlighted that improvements were still needed across banks and that it would take time to reach an "adequate level". Consequently, in early 2017, the ECB announced its intention to develop comprehensive SSM guides on ICAAP and ILAAP for significant institutions to enhance harmonisation.

As part of this initiative, the ECB has consulted on seven guiding principles. Further changes may be made after the 2017 SREP and the guides are planned for publication and consultation in early 2018. The seven principles are summarised below:

- Management bodies are responsible for ICAAP and ILAAP.
- ICAAP and ILAAP are integral parts of risk management frameworks.
- ICAAP and ILAAP aim to ensure an institution's viability over the short and medium-term. Both a normative perspective (based on fulfilling regulatory requirements) and an economic perspective (which includes all risks) should be assessed.
- ICAAP and ILAAP should identify and consider all material risks.
- Capital and liquidity need to be of high quality and clearly defined.
- Assumptions and methodologies need to be proportionate, consistent and thoroughly validated.
- There should be regular stress testing aimed at ensuring viability under adverse conditions.

Scope Ratings AG

Headquarters Berlin

Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main

Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389-0

Paris

33 rue La Fayette
F-75009 Paris

Phone +33 1 82 88 55 57

London

Suite 301
2 Angel Square
London EC1V 1NY

Phone +44 203-457 0 4444

Madrid

Paseo de la Castellana 95
Edificio Torre Europa
E-28046 Madrid

Phone +34 914 186 973

Milan

Via Paleocapa 7
IT-20121 Milan

Phone +39 02 30315 814

Oslo

Haakon VII's gate 6
N-0161 Oslo

Phone +47 21 62 31 42

info@scoperatings.com
www.scoperatings.com

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