EUROPEAN CENTRAL BANK
BANKING SUPERVISION

Press release

10 February 2022

ECB requires banks to hold marginally more capital in 2022

- SREP results show banks have solid capital and liquidity positions, with scores broadly stable
- Overall capital requirements and guidance increase marginally to stand at 15.1% of risk-weighted assets in 2022, up from 14.9% in 2021
- Overall capital requirements and guidance in CET1 rise to 10.6% of risk-weighted assets, up from 10.5%
- Credit risk and internal governance remain key areas in terms of supervisory action

The European Central Bank (ECB) has today published the results of its Supervisory Review and Evaluation Process (SREP) for 2021. The findings of that annual assessment indicate that significant institutions have maintained solid capital and liquidity positions, with most banks operating at capital levels above those dictated by capital requirements and guidance. Banks' scores remain broadly stable overall.

The results of the 2021 SREP cycle reflect both the resilience of Europe's banking sector, which has played an important role in the euro area's economic recovery, and the challenges that lie ahead.

In particular, there is still uncertainty regarding the future trajectory and evolution of the pandemic, with supply chain disruption currently weighing on trade and overall economic activity. There are also other risks on the horizon stemming from a broad range of uncertainties, including the possibility of cyberattacks, climate-related risks, continued pressure on profitability, and the potential for a disruptive exit from the low interest rate environment.

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The 2021 supervisory cycle signalled a return to normality, following the pragmatic approach adopted in 2020, when capital requirements were kept stable on account of the pandemic and supervisory concerns were addressed mainly by means of recommendations, rather than requirements.

Consequently, the 2021 SREP cycle involved the assessment of banks' capital, the assignment of SREP scores to banks' overall risk profiles and their main elements, and the issuance of formal decisions in addition to recommendations.

On average, banks have maintained solid capital and liquidity positions throughout the pandemic. Overall capital requirements and guidance have increased slightly for 2022, averaging around 15.1% of risk-weighted assets (RWAs), compared with 14.9% in the pragmatic 2020 SREP assessment. The average amount of overall capital requirements and guidance in CET1 has increased to around 10.6% of RWAs, up from 10.5%.

The marginal increase in total capital has been driven by Pillar 2 capital requirements (P2Rs), which have risen to 2.3%, up from 2.1%. That is mostly due to the introduction of a specific requirement (a provisioning shortfall add-on) imposed on banks which have not booked enough provisions to cover the credit risk on non-performing loans (NPLs) granted before 26 April 2019. Banks that actively address their shortfall in provisions vis-à-vis ECB expectations will be able to swiftly reduce that new add-on in the course of 2022 without waiting for the next SREP assessment.

Pillar 2 guidance (P2G), which captures risks indicated by the results of stress tests, has increased by 0.2 percentage points to stand at 1.6%, up from 1.4%. Only six banks failed to comply with their P2G at the end of 2021, and they did so because of structural issues that predated the pandemic.

As part of the ECB's relief measures, banks can make full use of their capital buffers or their P2G until the end of 2022. By 1 January 2023 – as communicated in a separate press release – the ECB expects banks to be operating above the level of their P2G.

"We are broadly satisfied with the way that banks have operated so far during the pandemic. They have contributed to the resilience of the euro area economy and continued to grant credit to households and firms," said Andrea Enria, Chair of the ECB's Supervisory Board. "However, the pandemic's impact on the economy is not over yet. Banks need to remain aware of the possible consequences for their balance sheets and strengthen their risk control and governance frameworks in particular."

The SREP 2021 results show broad stability in terms of scores. This is another sign of the banking system's resilience, given that banks' overall scores might well have deteriorated significantly during the pandemic.

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In the 2021 cycle, credit risk and internal governance were the two main areas in terms of remedial measures requested of banks.

Supervisors looked closely at the adequacy of institutions' credit risk controls. Several banks were found to have insufficiently strong credit risk management practices, with some having inadequate provisioning processes. In those cases, the ECB downgraded credit risk scores and required more follow-up actions.

Stocks of NPLs have continued to decline, thanks in particular to banks' consistent execution of plans to reduce and dispose of NPLs. The quality of credit on banks' balance sheets has remained fairly robust overall, thanks in part to exceptional public support measures. However, there are also some signs of deteriorating credit quality, particularly in the economic sectors that have benefited most from support measures, and those developments will need to be monitored carefully.

Findings in the area of internal governance point to weakness in boards' steering capabilities and governance arrangements such as risk control frameworks. This can hamper risk management and compliance functions, as well as IT transformation plans, impeding the resolution of data aggregation issues. Many banks also need to take steps to improve the composition and collective suitability of their management bodies, as they continue to place insufficient emphasis on diversity (e.g. as regards gender and professional expertise). With that in mind, the ECB is using operational acts to require banks to establish diversity policies and set gender-related targets.

Meanwhile, the assessment of business models shows that most banks are still failing to generate returns that exceed the cost of capital. Profitability recovered in 2021, but it remains structurally low overall. Supervisors' concerns in this regard relate primarily to long-standing issues that predated the pandemic, such as unsatisfactory strategic plans and/or inadequate execution of such plans.

The P2Rs applicable to individual banks in 2022 have been published on our website. Consent to publish that information has been obtained from all banks which were the subject of a SREP 2021 decision.

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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; risks to capital; and risks to liquidity and funding.

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

- The **2021 SREP assessment cycle** was generally based on year-end data for 2020. The decisions resulting from the 2021 SREP assessment are applicable in 2022.
- **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 (G-SIIs), other systemically important institutions (O-SIIs) 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 by, 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 here for additional information on the composition of the capital stack. All figures are reported as percentages of risk-weighted assets.
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