EUROPEAN CENTRAL BANK

BANKING SUPERVISION

Press release

28 January 2021

ECB asks banks to address credit risk and improve efficiency

- Overall SREP requirements and guidance stable as a result of pragmatic SREP approach
- Banks show resilience, but vulnerabilities remain in several areas, particularly credit risk
- Supervisory priorities for 2021: credit risk management; capital strength; business model sustainability; and governance

The European Central Bank (ECB) published today the outcome of its 2020 Supervisory Review and Evaluation Process (SREP) and announced its supervisory priorities for 2021.

This year's SREP results reflect an early decision by the ECB to take a pragmatic approach towards conducting its annual core activities on account of the coronavirus (COVID-19) pandemic.

The ECB's pragmatic approach to the SREP focused on banks' ability to address the challenges and risks to capital and liquidity arising from the ongoing pandemic. The ECB decided that the Pillar 2 requirements (P2R) and Pillar 2 guidance (P2G) would be kept stable, and that the SREP scores would not be updated, unless changes were justified by exceptional circumstances affecting an individual bank. Supervisory concerns were addressed mainly through qualitative recommendations rather than supervisory measures.

Euro area banks began 2020 with significantly higher capital levels and far greater resilience to economic deterioration than was the case in the great financial crisis.

Coordinated policy measures, including extraordinary supervisory measures, provided considerable protection to households and businesses as well as to the banking sector, averting excessive procyclicality from the pandemic-induced shock.

Ample capital buffers remained available from the third quarter of 2020. Significant uncertainties remain in the short to medium term and SREP data indicate an ongoing need for vigilance and continued

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supervisory challenges in several critical areas, relating in particular to the risk of a sudden increase in non-performing loans.

In the context of the ECB's pragmatic approach, the SREP capital requirements and guidance (excluding systemic buffers and the countercyclical capital buffer) for the 2020 cycle remained consistent with the 2019 cycle, standing at around 14% on average.

The P2R also remained stable, at an average of around 2.1% for the SREP 2020, except for a few cases, such as those where banks were given a P2R for the first time during the 2020 SREP cycle after becoming subject to direct supervision by the ECB.

At the same time, the Common Equity Tier 1 component of the P2R (P2R CET1) decreased to 1.2% from 2.1% due to the frontloading by the ECB of the revised Capital Requirements Directive (CRD V) rules. As a result, the CET1 component of the SREP capital requirements and guidance (excluding systemic buffers and the countercyclical capital buffer) decreased to 9.6%.

The P2G also remained stable at around 1.4% owing to the postponement of the EU-wide stress tests coordinated by the European Banking Authority (EBA) to 2021.

The main findings identified during the SREP in 2020 concerned credit risk, capital adequacy, business model sustainability and internal governance. These findings were addressed through qualitative recommendations. Given that the ECB postponed the deadlines of previous SREP qualitative measures, a large number of findings remain unaddressed and unresolved from previous SREP cycles, in particular those on internal governance.

With regard to credit risk, the supervisory focus was on adequate classification and measurement of risks in banks' balance sheets and on banks' preparedness for dealing with distressed debtors in a timely manner. Deteriorating economic conditions during the pandemic slowed the pace of the ongoing reduction in non-performing loans but there is also an embedded level of distress in loan books that is not yet fully evident. The phasing-out of several support measures in 2021 may increase the risk of cliff effects. To encourage appropriately prudent approaches, supervisors have communicated a considerably higher number of recommendations to banks.

With regard to internal governance, the risks stemming from the COVID-19 pandemic were adequately managed and monitored by most banks. Nonetheless, some banks were slow to address pandemic-related governance challenges. Supervisors found, in some cases, that there was a lack of adequate involvement by the management body, with insufficient follow-up and oversight of business functions, particularly in relation to reporting adequacy. Furthermore, there were also issues regarding credit risk management within the internal control functions and sustained structural weaknesses in the area of risk data aggregation and reporting.

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With regard to the business model, supervisors expressed concerns about the reliability of business plans for some banks and addressed these through qualitative recommendations to improve profitability. Profitability fell in 2020, mainly owing to higher impairment flows, lower net interest income and a decline in fees and commissions. Decreasing margins intensified the pressure on banks to adjust their cost bases, leading to a number of cost-cutting measures over the course of 2020, such as branch consolidation, innovation projects and remote working arrangements. Recent events have pushed the trend towards the digitalisation of internal processes, albeit one in four banks is still facing delays in delivering on such initiatives. Banks have also responded to the challenges posed by pursuing broader strategic overhauls or restructuring plans as well as domestic consolidation operations. Supervisors have been encouraging banks to pursue these strategic overhauls and improve efficiency and are closely monitoring the implementation of banks' strategic actions.

With regard to capital adequacy, supervisors expressed concerns about the reliability of banks' capital planning frameworks, for example in relation to their ability to produce reliable capital projections covering a three-year time horizon, as part of their internal capital adequacy assessment process (ICAAP) assessment. Banks with low capital headroom, that is with a small margin between their capital ratio and minimum requirements, were subject to recommendations to enhance their capital planning. As part of the ECB's relief measures, banks may fully use capital buffers, including Pillar 2 guidance, until at least the end of 2022. Overall, nine banks are making use of these measures, with CET1 levels based on the third quarter of 2020 being below the CET1 requirements and guidance prior to the COVID-19 measures.

Based on the SREP analysis and taking into account the situation triggered by the pandemic, ECB Banking Supervision decided to concentrate its efforts on four key areas materially affected by the current crisis situation, setting the following supervisory **priorities for 2021**: credit risk; capital strength; business model sustainability; and governance.

As regards credit risk, supervisors will focus on the adequacy of banks' credit risk measurement and management, with a view to fostering timely identification, efficient monitoring and the mitigation of procyclicality.

As regards capital strength, the EU-wide stress test coordinated by the EBA will be at the forefront and will be an important element in gauging banks' capital resilience, in addition to the continued supervisory review of banks' capital planning.

As regards business model sustainability, banks' strategic plans and the underlying measures taken to overcome existing structural deficiencies will continue to be challenged.

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As regards internal governance, the supervisory focus will remain on the adequacy of banks' crisis risk management frameworks, risk data aggregation, IT and cyber risks, as well as anti-money laundering risks.

Andrea Enria, Chair of the Supervisory Board of the ECB, will further comment on the SREP 2020 findings at a press conference starting at 9:00 CET on Thursday, 28 January 2021. Follow live on the ECB's banking supervision website.

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