RegCORE Client Alert

Financial Services: ECB-SSM publishes its 2021 SREP findings setting the tone for supervisory dialogue for 2022

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On 10 February 2022, the European Central Bank (**ECB**), acting in its Banking Union supervisory role at the head of the Single Supervisory Mechanism (**SSM**) published the results of the Supervisory Review and Evaluation Procedure (**SREP**)[1] that was concluded for the year 2021 (**SREP 2021**).

SREP is an important supervisory tool used by the ECB-SSM but also by national competent authorities (**NCA**s) in setting the tone for the supervisory dialogue along with priorities as part of the ECB-SSM's overall compliance assessment and BUSI-specific findings. SREP acts as a supervisory scorecard in respect of Banking Union supervised institutions (**BUSI**s). This scorecard takes the form a formal decision (a legally

[1] The SREP process itself has been evolving rapidly over the past couple of years − starting as a national-centric process, with the national competent authorities (**NCA**s) influenced by Basel III/IV, to becoming one that is shaped by supervisory approaches in the Banking Union. The SSM-run SREP continues to build off EU-wide methodology set by the European Banking Authority (**EBA**). However, it also contains some SSM specifics and its own methodology, which it refines and updates periodically. Some of the differences include the style of its approach, evaluation of its findings and this is crucial in allowing the ECB-SSM to set remedial actions BUSIs are expected to address. These remedial actions include both quantitative measures, such as capital add-ons including the Pillar 2 Requirements (**P2R**), as supplemented by Pillar 2 Guidance (**P2G**), as well as details on remedial action and relevant qualitative measures. Unlike the P2R, the P2G is not legally binding but the ECB-SSM expects BUSIs to follow and apply the P2G in full.

In summary, the SSM-run SREP looks at BUSIs operations and whether they have:

- an effective business model (*the supervisors review in particular if BUSIs have a viable and sustainable business strategy*)
- robust internal governance (*the subject of the review here is the capabilities of the management bodies; effectiveness of risk management*)
- sufficient regulatory capital (*sufficiency of buffer to absorb losses*)

binding administrative act) that sets out regulatory capital requirements, including beyond regulatory own funds, that are to be maintained by the individual BUSI.

In case a BUSIs capital base is found to be inadequate, they will have to build up regulatory capital. Moreover, BUSIs may be required to improve their liquidity situation beyond the minimum regulatory requirements, or they may be required to remedy identified deficiencies. Together these measures are intended to ensure that BUSIs remain sufficiently resilient even under adverse business conditions, thus contributing to the maintenance of financial stability in the Banking Union overall.

Following up on the SREP process, supervisors will monitor BUSIs' compliance with the requirements and measures detailed in the SREP decisions addressed to individual BUSIs during off-site analysis and, if required, through on-site inspections over the SSM's 2022 supervisory cycle.

This Client Alert assesses the ECB-SSM's findings in relation to the 2021 SREP, the relevant remedial actions and opportunities for BUSIs and an overview of how this might fit into a range of supervisory touchpoints already underway or scheduled in the SSM's 2022-2024 supervisory priorities, notably given the ECB-SSM's reinvigorated focus of looking beyond the pandemic and increasing BUSI's future resilience including against future and very much novel risks.[2]

BUSIs and their affiliates may equally wish to read this analysis in the context of actions taken by non-Banking Union supervisors, whether they use SREP as a supervisory tool or not, and the wider set of measures discussed in greater detail from PwC Legal's Frankfurt-based EU Regulatory Compliance Operations, Risk and Engagement (**EU RegCORE**) centre.

A return to normal SREP procedures?

During 2020, the ECB-SSM adopted a pragmatic pandemic-adjusted approach to carrying out the SSM-run SREP process. In 2021 the SSM reverted to a full SREP cycle. Supervisors focused their 2021 analysis in line with the ECB-SSM 2021 supervisory priorities as it began to plan for beyond the pandemic. Hence, the 2021 SREP cycle covered:

- a full capital assessment;
- the assignment of SREP scores to BUSI's overall risk profiles and their main elements; and
- the issuance of formal decisions, rather than just recommendations (as had been the case for 2020 findings to be remedied during 2021 i.e., allowing for some leeway).

A full exit of temporary and very much 'pandemic preparedness' relief measures was announced as being anticipated as of the end of 2023. It is however important to note that the SREP 2021 findings were issued well ahead of the emerging geostrategic tensions and adverse impacts on the European banking sector that emerged as February 2022 drew to a close.

Details in the 2021 findings – tracking through to supervisory engagement for 2022

Notwithstanding the SSM-run SREP's design, certain BUSIs may still be exposed to surprises in the content of their individual decisions i.e., the grade on the scorecard and commentary addressed to them as well as the overall tone set in the 2021 findings published 10 February 2022. Therefore, it remains important that BUSIs seek legal support throughout the process to ensure that certain issues are addressed in a timely fashion, both internally and externally.

- adequate liquidity (funding the BUSI in a sustainable way, ability to cover short-terms cash needs).

The outcome of this assessment is then translated into scores as follows:

Score	Assessment
1	There is a low risk that the BUSI may face material consequences (losses)
2	There is a low to medium risk that the BUSI may face material consequences (losses)
3	There is a medium to high risk that the BUSI may face material consequences (losses)
4	There is a high risk that the BUSI may face material consequences (losses)
F	Fail

[2] This Client Alert should be read in conjunction with a more visual analysis available here.

This is notably the case given that once the final SREP assessment is provided, BUSIs may only provide comments regarding the accuracy of the data but not the assessment as presented in the draft version of the individual decision i.e., a rulemaking instrument, that is addressed to them.

Furthermore, every SREP decision suspends the previous one, which implies that supervised institutions need to act swiftly to ensure compliance in a timely manner. In addition, they need to provision for the appropriate management of outstanding issues and identified deficiencies, as the ECB-SSM's Joint Supervisory Teams (as well as the supervisory teams at NCAs) monitor the remediation progress closely and often expect detailed follow-ups and even encompassing remediation programs.

As a result of the approach discussed above, traditional remediation efforts during 2022 ahead of the next findings to be published in 2023 will (likely continue to) spin over the "lifetime" of several SREP reiterations over a multi-annual supervisory cycle. As in cases prior to the pandemic, they will require a comprehensive issue management framework (including governance, legal support, oversight, etc.) to ensure compliance with the SREP decision's requirements, as well as to avoid any subsequent ECB decisions, which may impose additional requirements in the event that the BUSI fails to meet its SREP obligations over the preceding supervisory lifecycle.[3]

Key findings flowing from SREP 2021

The results of SREP 2021 acknowledged both the resilience of the European banking sector but equally the potential emerging risks and vulnerabilities. Overall, SREP scores remained broadly stable for the 2021 findings, with significant institutions maintaining solid capital and liquidity positions and most BUSIs going beyond the levels dictated by capital requirements and guidance. That being said, overall scores remained low.

A key finding in the SREP 2021's general commentary related to internal governance and the ECB-SSM's perception of continued deficiencies in the internal control and processes as well as a lack of diversity and sufficient strategic steering culture in boards notably in challenging decisions and ensuring such challenge was sufficiently documented. This extended to the ECB-SSM considering that many BUSIs (at least 30%) lacked diversity and collective suitability in its boards as well as these paying insufficient attention to risk and compliance along with a weak IT landscape impairing data aggregation and reporting capability for boards and executive functions to drive strategic steering.

The concerns on corporate governance were coupled with a (renewed) concern on credit risk and the adequacy of processes and controls as well as staging and provisioning. Credit risk scoring saw the biggest downgrades with a significant majority of BUSIs scoring 3 or 4 and being subject to significant qualitative measures. These in turn are reflected in Pillar 2 Requirements (**P2R**) and Pillar 2 Guidance (**P2G**) add-ons to regulatory capital requirements.

P2R is a capital requirement which applies in addition to and covers risks which are underestimated or not covered by the minimum capital requirement (known as **Pillar 1**). P2Rs are binding and breaches can have direct legal consequences for BUSIs. The P2R is determined via the SREP. The capital demand resulting from the SREP also includes the P2G, which indicates to BUSIs the adequate level of capital to be maintained to provide a sufficient buffer to withstand stressed situations.

Capital requirements and guidance

The SREP results can be summarised as follows:

- the overall capital requirement and guidance increased slightly in 2021, averaging around 15.1% of risk-weighted assets;
- the P2R increased from 2.1% in 2020 to 2.3% in 2021, especially because of the introduction of new non-performing exposure/loans (collectively **NPL**) provisioning shortfall add-ons. Its guidance also increased by 20 basis points on average (rising from 1.4% in 2020 to 1.6% in 2021) concerning the increased capital depletion indicated by the 2021 stress test; and

[3] BUSIs, especially those with cross-border activities, specifically with non-EU operations, may wish to seek legal counsel to be able to manage any requirements and/or remediation programs that affect them on a group/sub-group/entity level, as certain NCAs across the EU have country-specific rules. BUSIs with cross-border activities may need to manage deficiencies on several levels, where local and/or consolidated supervisors demand to have the issues managed locally, to not share information beyond the borders of the specific location and/or to adhere to additional local regulatory requirements. Regardless of the supervisory touchpoints on SREP, whether SSM-led or not, the supervisory tone of the competent authorities is increasingly focusing on qualitative standards in addition to its much more established track record in reviewing quantitative metrics.

- according to ECB-SSM the increase of P2G and requirements was partly offset by a decline in the average countercyclical capital buffer, which was negligible in 2021, having stood at 0.2% of risk weighted assets (**RWA**s) in 2020.

Evolution of scores

The ECB-SSM pointed out that the SREP 2021 scores are in the overall, stable and remained largely unchanged. According to the ECB-SSM this is a consequence of the EU banking system's resilience and the success of the support measures deployed by national and European authorities during the pandemic. Despite this good news, some BUSIs were found to have inadequate forward-looking planning in terms of their capital adequacy as well as in relation to their dividend plans – in particular following the expiry of the ECB-SSM's pandemic related pause on dividend payments. While overall, 82% of BUSIs in the SREP 2021 remained stable in their scores, amongst those that are categorised for SSM purposes as "diversified lenders" approximately 70% thereof received a SREP score of 3 to 4.

Qualitative measures

The ECB-SSM stated that the vast majority of those BUSIs that are significant credit institutions (**SCI**s), and thus ECB-SSM directly supervised, as opposed to less significant institutions (**LSI**s), i.e. those which are directly supervised by NCAs and indirectly by the ECB-SSM, were asked to implement qualitative measures in response to their supervisory findings in their SREP 2021 results. Overall, 32% of BUSIs were downgraded in their SREP scores and 70% received qualitative measures in the form of P2R/P2G.

According to the ECB-SSM the requested measures broadly reflect the specific areas identified in the SSM's supervisory priorities of the for 2021:

- increase of by 25% of the internal governance and risks management measures;
- credit risk measures increased making up 26% of total measures;
- decline of the measures relating to business models in comparison of 2020, they accounted for 9% of the total in 2021; and
- capital adequacy measures remained broadly stable, accounting for a limited share of total measures: 14%.

Analysis of the key elements in the 2021 SREP

Business models

Results:

The results regarding the review of the business model component can be summarised as follows:

- cyclical factors such low interest rates and structural factors such as overcapacity, low cost efficiency and growing competition from BUSIs and non-bank financial services institutions (**NBFI**s) continue to challenge the business models of SCIs (notably 70% of those BUSIs categorised as "diversified lenders" and 65% of those categorised by the SSM as "retail/consumer credit lenders" had a REP score of 3 or 4;
- despite recovery of significant institutions profitability in 2021 (thanks to lower impairments – notably on NPLs), it remains structural profitability remains low overall, specifically the return on equity (**ROE**) is below the cost of capital, which reduces the ability to issue more capital when needed;
- with the exception of small lenders and retail and consumer lenders, a recovery in profits was observed for most business models in 2021 but many lag on transformation and delivery of strategic programmes. 20% of BUSIs were downgraded and only 7% improved their position – largely thanks to implementation of successful transformation projects; and
- structural factors remain one of the key supervisory concerns for the European banking sector, as they weigh on the sustainability of BUSIs' profits.

Supervisory expectations

Supervisors focused on the future resilience of BUSIs and the sustainability of their business models, as well as the weaknesses that BUSIs faced prior to the COVID 19 pandemic e.g. such as delays in the implementation of strategies and the need for further strategic transformation.

Internal governance and risk management

Results:

In connection with the internal governance review, the supervisors identified the following weaknesses regarding:

- management bodies of SCIs here the supervisors noticed the following:
  - o evidence of missing effectiveness of the management bodies and their strategic steering capabilities;
  - o some management bodies were found to be performing their supervisory function insufficiently;
  - o moreover, their attention to the risk and compliance function was found to be rather low (e.g., weak monitoring and insufficient follow-up on their findings); and
  - o the efficiency of management bodies in terms of their composition and collective suitability is considered problematic. Moreover, it is noted that insufficient efforts are being made to achieve gender diversity (e.g. absence of diversity policy, insufficient quantitative gender targets, etc.); and
- concerning the state of IT Systems:
  - o IT Systems were found to be fragmented and not harmonised which has a negative impact on data aggregation and reporting for management and regulatory purposes.

Supervisory expectations

In the SREP 2021 findings, the largest group of qualitative measures relating to internal governance and risk management focused on the:

- need to improve internal control functions;
- measures relating to the management body and strategic steering;
- measures concerning IT infrastructure, data aggregation;
- reporting; and
- remuneration.

Credit risk

Results:

As a result of the SREP, that the ECB-SSM concluded that COVID-19 related credit risk concerns in the form of an increase in NPLs have not yet materialised (although the ECB-SSM has repeatedly stated that this risk could return rapidly if the economic recovery is derailed and governmental administrated and other support measures cease or otherwise expire), with high-level measures of credit risk showing improvement. Specifically, this assessed that:

- the amount of loans covered by the EBA Guidelines on loan moratoria[4] declined further throughout 2021;
- NPLs also continued to decline in 2021, partly on account of increased provisioning for legacy assets and partly as a result of specific P2R conclusions where supervisory expectations for NPL provisioning were not met.
- However, the future dynamic of the pandemic remains uncertain. The supervisors noted that a lot of BUSIs do not have sufficiently strong credit risk practices and this is a point that is also earmarked for future review in various forms in the SSM's Supervisory Priorities for 2022 as echoed by actions of other EU level and other national level authorities. The supervisory review focused on two aspects, in particular asset quality and credit risk controls.

With regard to asset quality, the SREP 2021 findings reported improvements during 2021. Notably, by the end of September 2021, the volume of NPLs held by SCIs had fallen to €402 billion (a 42% reduction relative to December 2015), albeit significant heterogeneity continued to be observed across BUSIs.

The SREP 2021 findings regarding the credit risk control led to a significant number of qualitative measures related to institutions' ability to identify and react to the deterioration of credit risk.

Supervisory expectations

As mentioned above supervisors issued a significant number of qualitative measures addressing BUSI-specific concerns on credit risk, with 70% of BUSIs receiving such requests institutions' ability to identify and react to the deterioration of credit risk.

[4] EBA/GL/2020/02; EBA/GL/2020/15.

Capital Adequacy and Internal Capital Adequacy Assessment Process (ICAAP)

Results:

The ECB-SSM noted the following:

- BUSIs' capital positions have strengthened significantly over the course of the pandemic, but their scores remained broadly stable in 2021 given the extent of public support measures
- BUSI's limited their dividend payments, in line with the expectations set out in the ECB-SSM's Dividend Recommendation issued shortly following the onset of the pandemic and which was applicable until 30 September 2021.

As part of the ECB-SSM's regulatory compliance reliefs, BUSIs were given the flexibility to dip into their capital conservation buffer or their P2G levels until the end of 2022.

Supervisory expectations

The ECB-SSM expressed in a number of cases its concerns about the reliability of BUSIs' capital planning frameworks (e.g., the ability to produce reliable capital projections with baseline and adverse scenarios over at least a three-year period) as part of their ICAAP assessments. As a consequence, several BUSIs were subject to planning requirements and recommendations aimed at enhancing their capital.

In addition to recommendations on the ICAAP framework more broadly, a number of recommendations focused specifically on:

- the ICAAP capital planning process (14% of all qualitative recommendations for this category of risk);
- dividend distribution (11%); and
- the identification and quantification of risks in the ICAAP (6%).

Hence, these three subcategories accounted for roughly 30% of total qualitative recommendations for this category of risk.

Other risks identified and addressed by the SREP 2021

Market risks

As a result of the weaknesses identified in the SREP, it turns out that market risk will be one of the highest priorities for the SSM for the period 2022-2024. BUSIs need to strengthen their risk management capabilities to prepare for the challenges posed by an abrupt repricing of risky assets. Further supervisory priorities focus on counterparty credit risk management practices.

Operational resilience

IT and cybersecurity risks are a high-level and very much on-going priority area for the ECB-SSM. Examples of SREP measures in this field include requests for remediation plans where security vulnerabilities have been detected, requests for BUSIs to establish an IT strategy where no such strategy has been documented, and requests for adequate staffing of critical IT functions.

Tackling money laundering and the financing of terrorism

Prudential concerns focused mainly on issues relating to internal governance arrangements, business models and the management of operational risk. These were already reflected in different parts of the SREP 2021 assessments mainly concerning business models, internal governance and risk management for instance.

Outlook

As detailed in a separate thought leadership piece from our EU RegCORE - "Navigating 2022", the ECB-SSM assessed the main risks and vulnerabilities faced by significant institutions and established three supervisory priorities for the period 2022-2024:

- Making sure that BUSIs emerge healthy from the pandemic - supervisors will continue their efforts to address shortcomings in BUSIs' credit risk management practices, with a
- Addressing structural weaknesses via effective digitalisation strategies and enhanced governance; and
- Tackling emerging risks – which acts as a bit of a future catch-all category

For BUSIs but specifically SCIs, faced with remedial actions from the SSM-run SREP and a full list of impacts heading their way they may want to engage strategically with a mix of some "quick wins" and precautionary action in light of the 2022 Supervisory Priorities, notably in relation to improvements to governance, risk, control functions and digital and operational resilience.

As the ECB-SSM now is shifting to looking beyond the pandemic and a return to more normal yet more intrusive supervision, with a far greater breadth of supervisory tools at its disposal, firms will want to plan accordingly. Moreover, as discussed in detailed coverage from PwC Legal's EU RegCORE, the ECB-SSM in 2021 completed its own wide-reaching institutional reforms – its first since its inception in 2014. The ECB-SSM continues to embed a common supervisory culture across the various ECB and national level components, this dedicated drive for further harmonisation and Europeanisation of rulemaking and supervision will continue to shape how BUSIs will need to evidence compliance and design their supervisory engagement.

In summary and very much putting the 2021 SREP findings in the context of the SSM's overall 2022-2024 supervisory priorities, this means that BUSIs should look to identify and mitigate risks as well as plan for both pre-emptive and remedial measures in relation to:

Theme of ECB-SSM multi-annual supervisory priority 2022-2024	ECB-SSM identified risk	What the ECB-SSM might do
Market risk and IRBB	Sensitivities to shocks in interest rates and credit spreads	Targeted review to assess whether sound arrangements are in place to manage the impact of medium-term interest rate and credit spread shocks
Credit risk	1. Deficiencies in credit risk management framework 2. Exposures to leveraged finance (NB also Basel Committee on Banking Supervision policy statements on same topic – see our separate coverage) 3. Exposures to COVID-19 vulnerable sectors BUSI's exposure to vulnerable companies	1. Targeted reviews will be conducted on processes for timely identification, forward-looking measurement and mitigation of credit risks (including IFRS-9) 2. Inspection on the implementation of strengthened risk management and assessment of compliance with ECB-SSM Guidance 3. BUSI's exposure to vulnerable companies needs to be regularly monitored and managed (focus commercial real estate sector)
Market risk and credit risk	Exposures to CCR, especially towards NBFIs (NB also Basel Committee on Banking Supervision policy statements on same topic – see our separate coverage)	Targeted reviews and on-site inspections in the areas of counterparty credit risk governance and management will be performed 2023 (unless possibly (to be confirmed) this is delayed due geostrategic issues)
Business model	Deficiencies in BUSIs' digital transformation strategies	Supervisors will assess BUSIs' digitalisation strategies in order to ensure the latter have adequate arrangements in place (survey / benchmarking analysis / on-site inspections)
Climate and environmental risk	Exposure to climate-related and environmental risks	A climate stress test will be performed next year, as well as supervision on harmonisation of institutions' disclosure practices with supervisory expectations
Governance	Deficiencies in management bodies' steering capabilities	Supervisory activities will be performed in this area, tackling in particular the functioning and oversight and challenging capacity of management bodies
Operational risk	Deficiencies in IT outsourcing and cyber resilience	Supervisory activities addressing BUSIs' risk management practices in these areas will be progressively intensified

Finally, BUSIs, especially those with cross-border activities, specifically with non-EU operations, may wish to seek legal counsel to be able to manage any requirements and/or remediation programs that affect them on a group/sub-group/entity level, as certain NCAs across the EU have country-specific rules. BUSIs with cross-border activities may need to manage deficiencies on several levels, where local and/or consolidated supervisors demand to have the issues managed locally, to not share information beyond the borders of the specific location and/or to adhere to additional local regulatory requirements.

Regardless of the supervisory touchpoints on SREP, whether SSM-led or not, the supervisory tone of the competent authorities is increasingly focusing on qualitative standards in addition to its much more established track record in reviewing quantitative metrics.

About us

PwC Legal is assisting a number of financial services firms and market participants in forward planning for changes stemming from these proposals.

If you would like to discuss any of the developments mentioned above, or how they may affect your business more generally, please contact any of our key contacts or PwC Legal's RegCORE Team via de_regcore@pwc.com or our website.

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