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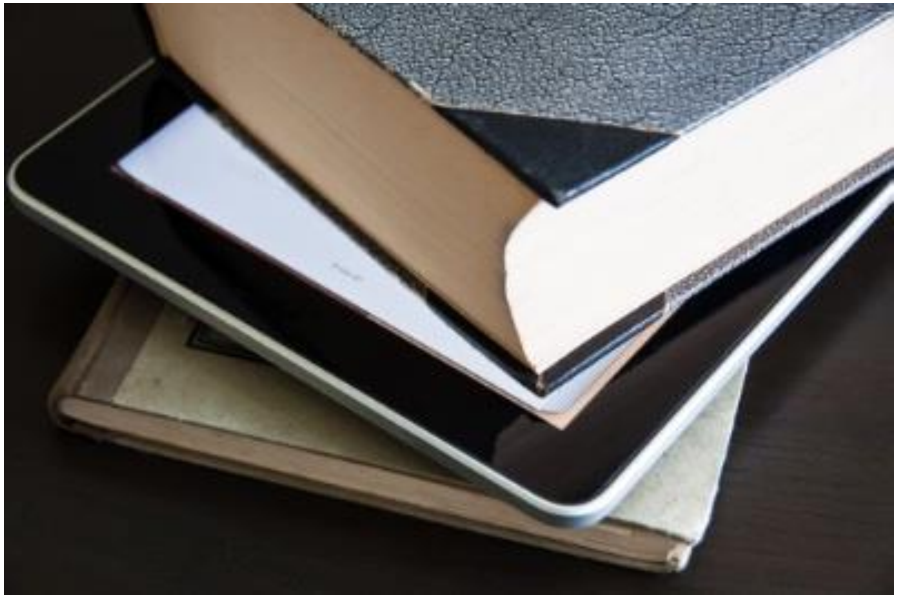
EBA draft SREP Guidelines
Overview of the proposed assessment approach and scoring requirements



July 2014

Overview: the EBA draft SREP Guidelines

- On July 7, the EBA published a consultation paper on **Guidelines for common procedures and methodologies for the supervisory review and evaluation process** under Article 107 (3) of Directive 2013/36/EU (CRD IV)
- The Guidelines are addressed to NCAs and cover **all aspects of SREP**, as illustrated
- For the purposes of the SREP, institutions are divided into **four categories**, based on their potential systemic impact, and supervised on a proportionate basis

Timeline:
- The consultation closes on 7 October 2014
- The Guidelines are expected to apply from 01 January 2016

The SREP framework

A. Categorisation of institutions

B. Monitoring of key institutions

C. Business Model Analysis

D. Assessment of internal governance and institution-wide controls

E. Assessment of risks to capital
- Assessment of inherent risks and controls
- Determination of own funds requirements & stress testing
- Capital adequacy assessment

F. Assessment of risks to liquidity and funding
- Assessment of inherent risks and controls
- Determination of liquidity requirements & stress testing
- Liquidity adequacy assessment

G. Overall SREP assessment

H. Supervisory measures
- Quantitative capital measures
- Quantitative liquidity measures
- Other supervisory measures

I. Early intervention measures

A. Categorisation of institutions

	Category	Monitoring of key indicators	Assessment of all SREP elements (at least)	Summary of Overall SREP assessment (by NCAs)	Minimum level of engagement
1	G-SIIs, O-SIIs, other institutions considered by NCAs as large or systemically important	Quarterly	Annual	Annual	Ongoing engagement with management body and senior management, engagement for assessment of each element
2	Large to medium institutions, domestic or with significant cross border activities, with several business lines, including non-banking activities. Non-systemically important specialised institutions with significant market share	Quarterly	Every 2 years	Annual	Ongoing engagement with management body and senior management, engagement for assessment of each element
3	Medium to small firms, domestic or with non-significant cross-border operations, offering predominantly credit products. Specialised institutions with less-significant market share	Quarterly	Every 3 years	Annual	Risk-based engagement with management body and senior management, engagement for assessment of material risk elements
4	All other small non-complex domestic institutions	Quarterly	Every 3 years	Annual	Engagement with management body and senior management at least every three years

Summary of proposed approach

- The elements of the SREP framework, as detailed below are assessed and scored on a 1 (no discernible risk) to 4 (high risk) scale. Scores are assigned on the basis of supervisory judgement
- The outcome of the assessments, both individually and considered in a holistic manner, form the basis for the Overall SREP assessment, which represents the up-to-date supervisory view of the bank's risks and viability
- The Overall SREP assessment should form the basis for supervisory measures

	Focus / Risks	Details	Criteria for Score 1
C. Business model analysis	• Business environment • Current business model • Forward looking strategy and financial plans • Business model viability • Strategy's sustainability • Key vulnerabilities	• NCAs should focus on the most important business lines, taking into consideration materiality, strategic importance, previous supervisory findings and outcomes of thematic reviews, recent changes, atypical performance compared to peers • Business model analysis should be qualitative (external and internal dependencies, franchise, competitive advantages) and quantitative (profits, losses, balance sheet, concentrations, risk appetite, including trends)	• Having strong and stable returns with an acceptable risk appetite and funding structure • No material asset or source of income concentrations • Strong competitive position • Plausible forecasting assumptions • Strategic plans appropriate for business model and management execution capabilities
D. Internal governance and institution-wide controls	• Overall governance framework • Corporate and risk culture • Organisation and functioning of the management body • Remuneration policies and practices • Risk management frameworks, including ICAAP and ILAAP • Information systems and business continuity • Recovery planning arrangements	• NCAs to assess if the institution's ethical, corporate and risk culture creates an environment of effective challenge • The assessment of risk management frameworks and processes should take into consideration Risk Appetite Framework (RAF) and strategy, ICAAP and ILAAP, and stress testing capabilities • RAF assessment should consider its comprehensiveness, consistency between risk appetite and risk strategy, review timed with strategic planning horizon, clearly defined management responsibility, consistency with financial resources, appropriate documentation, appropriate embedding • NCAs should determine the soundness, effectiveness and comprehensiveness of a institution's ICAAP and ILAAP • The assessment of information systems and business continuity should take into consideration the accuracy and reliability of risk data, ability to aggregate all material risk data, ability to generate aggregate risk data in a timely manner and to meet on-demand requests • NCAs should consider the group's structure and roles, links and risks associated with its entities and their interconnectedness • Relevant EBA guidelines: Guidelines on internal governance and on stress testing	• Robust and transparent organisational structure with clear separation of risk taking and risk control functions • Remuneration policy aligned with risk strategy and long term interests • Appropriate risk management framework and processes including ICAAP, ILAAP, stress testing, capital and liquidity planning • Complete and credible recovery plan • Sound corporate culture • Appropriate information systems and business continuity arrangements

Summary of proposed approach

<table>
<tr><th></th><th>Focus / Risks</th><th>Details</th><th colspan="2">Criteria for Score 1</th></tr>
<tr><td rowspan="5">E. Risk to capital</td><td>Overall</td><td>• NCAs should assess risk exposure and risk management and controls
• Assessment of risk management and controls should consider risk strategy and appetite, organisational framework, policies and procedures, risk identification, measurement, management, monitoring and reporting, and internal control framework</td><td rowspan="5">• Nature and composition of credit and market risk and the significance of operational risk exposures implies non-material risk and risk concentration;
• Exposures are non-complex
• Non-material forborne and non-performing exposures
• Coverage of provisions and CVAs, coverage and quality of guarantees and collateral is very high
• Market risk exposures generate non-volatile returns
• Immaterial or decreasing level of past losses due to operational risk
• Sensitivity of economic value and earnings to changes in interest rates or the underlying assumptions in not material</td><td rowspan="5">Management and controls:
• Consistency between credit, market or operational risk policy and strategy and overall strategy and risk appetite
• Robust organisational framework
• Appropriate monitoring and reporting
• Internal limits and control framework is sound
• Limits are in line with risk management strategy and risk appetite</td></tr>
<tr><td>Credit and counterparty risk</td><td>• NCAs should consider credit risk concentration, counterparty credit risk and settlement risk, country risk, credit risk from securitisation, FX lending risk, and specialised lending</td></tr>
<tr><td>Market risk</td><td>• On and off-balance sheet market risks assessment should consider at least general and specific position risk, FX risk, commodities risk, CVA risk
• In relation to the banking book, market risk assessment should consider credit spread risks arising from positions measured at fair value, risks arising from equity exposures, structural foreign exchange rate risk</td></tr>
<tr><td>Operational risk</td><td>• NCAs should consider model risk, reputational risk, conduct risk, and IT risk
• Under conduct risk, NCAs should consider product mis-selling, cross-sales, conflict of interests, benchmark manipulation, barriers to switching, design of distribution channels, automatic renewals and complaints handling</td></tr>
<tr><td>Interest rate risk from non-trading activities (IRRBB)</td><td>• NCAs should consider at least maturity timing mismatch risks, yield curve risk, basis risk and option risk</td></tr>
<tr><td>E. SREP Capita Assessment</td><td>The SREP capital assessment process:
• determination of the additional own funds requirements
• reconciliation with the CRD buffers and any macro-prudential requirements
• determination and articulation of the TSCR and OCR
• assessment of the risk of excessive leverage
• assessment of whether the OCR and TSCR can be met over the economic cycle
• determination of the capital score</td><td>• NCAs should determine additional own fund requirements on a risk-by-risk basis, using supervisory judgement, ICAAP calculations, the outcome of supervisory benchmark calculations, and other relevant inputs
• The reliability of ICAAP calculations should be assessed against their granularity, credibility, understandability, and comparability
• Additional own funds should cover model deficiencies, funding risk, and deficiencies in control or governance
• Additional own fund requirements covering (i) credit, market, and operational risks, (ii) credit concentration and IRRBB, (iii) risk from model deficiencies – in all cases, the composition of capital should be at least 56% CET1 and 75% Tier 1 capital
• Total SREP capital requirements (TSCR) = 8% x (TSCR x 12.5 / Total risk exposure amount (TREA))
• Where relevant, the NCAs should also articulate the Overall Capital Requirements (OCR) as ratio of TREA
• OCR should be met over the forecast economic cycle and TSCR during stress scenario
• In assessing risk of excessive leverage, NCAs should consider peer comparisons, historical data, impact of stress events, adequacy of leverage ratio for considering such risks</td><td colspan="2">• Own funds comfortably above the OCR and expected to remain so looking forward
• Stress-testing does not reveal any discernible risk regarding the impact on own funds
• Free flow of capital between entities in the group is unimpeded and all entities are capitalised above requirements
• Plausible and credible capital plan that has the potential to be effective
• Leverage ratio is comfortably above regulatory requirements and there is no discernable risk of excessive leverage</td></tr>
</table>

Summary of proposed approach

	Focus / Risks	Details	Scoring criteria	
F. Risk to liquidity funding	• Liquidity needs in the short and medium term, • Intraday liquidity risk • Liquidity buffer and counterbalancing capacity • Supervisory liquidity stress testing	• Short term liquidity risk assessment should be supported by analysing whether the LCR, once introduced, is correctly reported and if it adequately identifies liquidity needs • Assessment of liquidity buffers and counterbalancing capacity should be made over different time horizons – overnight, a month, up to a year • The institution's ability to monetise its liquid assets in a timely fashion should be assessed • NCAs should use liquidity stress tests. Once LCR is introduced, stress scenarios can be anchored to the LCR 30-day assumptions or extended over 30 days • NCAs should consider the relatively riskiness of institutions, combining institution-specific and market-wide stress • Assessment of inherent funding risk should take into account the institution's funding profile and risks to its stability, actual market access and assessment of expected change in funding risks • Assessment of risk management should consider liquidity risk strategy and risk tolerance, organisational framework, policies and procedures, risk identification, measurement, monitoring and reporting, institution-specific stress testing, internal control framework, contingency plans and funding plans	Liquidity risk: • No discernible risk arising from mismatches (e.g. between maturity, currency) • Adequate size and composition of liquidity buffers • Immaterial other drivers of liquidity risk e.g. reputation risk and inability to transfer intra-group liquidity Funding risk: • No discernible risk from funding profile and its sustainability • Immaterial other drivers of funding risk e.g. reputation risk and access to funding markets	Adequate management and controls: • Consistency of the institution's liquidity and funding risk policy with its overall strategy and risk appetite • Robust organisational framework • Appropriate measurement, monitoring and reporting • Internal limits and control framework is sound • Limits mitigate or limit liquidity and funding risk
F. SREP liquidity assessment	The SREP liquidity assessment process: • overall assessment of liquidity • determination of the need for specific liquidity measures • quantification of potential specific liquidity requirements – benchmark calculations • articulation of specific liquidity requirements • determination of the liquidity score	• The overall assessment of liquidity should consider the institution's ILAAP, outcomes of the supervisory liquidity and funding risk assessment and benchmark calculations, inputs from on-site inspections, peer group analysis, stress testing and other relevant inputs • The ILAAP framework should be assessed against its credibility and understandability • Institution-specific liquidity assessment should consider business model and strategy, ILAAP, supervisory assessment of liquidity risks, and potential systemic liquidity risks • Supervisory benchmarks should be developed as quantitative tools to facilitate comparable outcomes and calculations • The NSFR, once implemented, can be used as an anchor point for setting specific requirements on stable funding, if needed • NCAs can use one of three approaches to articulate quantitative liquidity requirements – requiring above-minimum LCR, setting a minimum survival period, or requiring a minimum total amount or liquid assets or counterbalancing capacity	• Counterbalancing capacity and liquidity buffers comfortably above specific supervisory quantitative requirements and are expected to remain so on a forward-looking basis • Composition and stability of longer term funding pose no discernible risk • Free flow of liquidity between entities within a group is unimpeded or all entities have a counterbalancing capacity and liquidity buffers above supervisory requirements • Plausible and credible liquidity contingency plan	

Overall SREP score and supervisory measures

G. Overall SREP assessment
The overall SREP assessment results in a determination of the institution's viability and the supervisory measures, including early intervention measures, taken on the basis of this assessment.

- When determining the overall SREP assessment, NCAs should consider:
  - the risks to which the institution is or may be exposed
  - the likelihood that the institution's governance, controls deficiencies and/or business model or strategy are likely to exacerbate or mitigate these risks, or expose the institution to new sources of risk
  - whether the institution's own funds and liquidity resources provide a sound coverage of these risks
  - the potential for positive and negative interaction between the elements

Overall SREP score: top scoring criteria:

- Business model and strategy do not raise concerns
- Internal governance and institution wide control arrangements do not raise concerns
- Institution's risks to capital and liquidity raise no discernible risk of a significant prudential impact
- Composition and quantity of own funds do not raise concerns
- Liquidity position and funding profile do not raise concerns

The score has four positive grades to be applied to viable institutions (1-4) and one negative grade ('F') - indicating that the NCA has determined that the institution is 'failing or likely to fail'

H. Supervisory measures

Capital measures	• Additional own funds requirements • Requiring the institution to use net profits to strengthen own funds • Restricting or prohibiting distributions or interest payments • Requiring the institution to apply a specific treatment of assets	Liquidity measures	• Specific liquidity requirements, including restrictions on maturity mismatches • Other administrative measures, including prudential charges

Area	NCAs can require an institution to
BMA	• Adjust its risk management and control arrangements, or governance arrangements, including by means of adjusting its financial plan, changing its organisational structure and functions, reinforcing its systems • Make changes to its business model or strategy • Reduce risks inherent in product offerings or its systems
internal governance and institution-wide controls	• Make changes to overall governance arrangements and organisation, including changes to organisational or functional structure, including reporting lines, amending risk policies, and/or increasing governance transparency • Make changes to the management body • Strengthen its overall risk management arrangements by improving ICAAP/ILAAP, reducing risk appetite or making changes to risk appetite governance or risk strategy, enhancing contingency planning • Strengthen internal controls including improvements in internal reporting and internal audit/risk control functions • Make changes to remuneration policies
Credit and counterparty	• Involve Management Body or Committees more actively, improve credit risk measurement and credit processes control, enhance collateral management • Apply specific provisioning policy • Apply floors to internal risk parameters or risk weights • Apply higher haircuts to the value of collateral • Hold additional own funds to compensate for difference between the accounting value of provisions and prudent valuation of assets • Reduce large exposures, tighten credit granting criteria, reduce specific exposures

Area	NCAs can require an institution to
Market risk	• Improve ability to identify, measure, monitor and control market risk, including via changes to stress testing or frequency of internal audits • Restrict investment or require divestment from certain products • Reduce market risk through hedging or asset sales, require an increase in derivatives cleared through CCPs
Operational risk	• Reduce outsourcing • Mitigate operational risk exposures e.g. via insurance • Involve Management Body / Committees more actively, consider risk in new products, improve risk identification and measurement
IRRBB risk	• Enhance stress testing or reporting • Apply variations to internal limits
Liquidity risk	• Reduce the concentration of liquid assets held • Restrict short-term contractual or behavioural maturity mismatches between assets and liabilities • Introduce more frequent reporting on liquidity positions • Improve risk identification and measurement
Funding risk	• Reduce dependency on certain funding markets, concentration of funding profile or amount of encumbered assets • Introduce additional/more frequent reporting • Enhance funding plan or place limits to risk appetite/tolerance • Enhance stress testing capabilities

Acronyms

- BMA: Business Model Analysis
- CCP: Central Counterparty
- CET 1: Common Equity Tier 1
- CRD IV: the revised Capital Requirements Directive
- CRR: the Capital Requirements Regulation
- CVA: Credit Valuation Adjustment
- EBA: European Banking Authority
- FX: Foreign Exchange
- G-SII: Global Systemically Important Institution
- ICAAP: Internal Capital Adequacy Assessment Process
- ILAAP: Internal Liquidity Adequacy Assessment Process
- IRRBB: Interest Rate Risk in the Banking Book
- LCR: Liquidity Coverage Ratio
- NCA: National Competent Authority
- NSFR: Net Stable Funding Ratio
- O-SII: Other Systemically Important Institution
- OCR: Overall Capital Requirement
- RAF: Risk Appetite Framework
- SREP: Supervisory Review and Evaluation Process
- TREA: Total Risk Exposure Amount
- TSCR: Total SREP Capital Requirement