Supervisory Review and Evaluation Process (SREP)

Banking Union

Implementation of EBA SREP guidelines by the ECB

DG IV
Methodology and standard developments division

Implementation into their supervisory approach → SSM supervisory manual

To be applied by → DG I/II
Significant banks supervision divisions

Guidance to NCA via → DG III
Less significant banks supervision division

Characteristics of the SSM supervisory approach

- Forward-looking, risk-based analysis
- Stronger focus on quantitative assessments
- Peer group comparison

Characteristics of the SSM supervisory approach

The SREP is used to calibrate additional capital and liquidity requirements beyond Pillar 1 minimum requirements. The SSM analyses the internal methodologies and conducts its own calculations for Pillar 2 during the SREP using a three-step approach:

1. Risk assessment system
   Evaluation of risks and respective controls
2. ICAAP and ILAAP review
3. Capital and liquidity quantification methodologies
   Determination of required capital and liquidity buffers based on the risk assessment

SSM decision
Outcome of analysis and corrective actions

Single Resolution Mechanism (SRM)

Single Rule Book

EBA guidelines for common procedures and methodologies for the SREP

Categorisation of institutions

Categories based on size, structure, internal organisation and nature, scope and complexity of activities	Systemically important (1)	Medium to large (2)	Small to medium (3)	Other (4)
	• Global systemically important institutions (G-SIIs) • Other systemically important institutions (O-SIIs) • Other institutions determined by competent authorities	• Domestically operating institutions or institutions with sizable cross-border activities • Institutions operating in several business lines, including non-banking activities • Institutions offering credit and financial products to retail and corporate customers • Non-systemically important specialised institutions with significant market shares in their lines of business or payment systems, or financial exchanges	• Domestically operating institutions or institutions with non-significant cross-border operations • Institutions operating in a limited number of business lines, offering predominantly credit products with a limited offer of financial products • Specialised institutions with less significant market shares in their lines of business or payment systems, or financial exchanges	Small non-complex domestic institutions that do not fall into categories 1 to 3
Level of engagement and dialogue	Ongoing engagement with institution's management body and senior management; engagement with institution for assessment of each element		Risk-based engagement with institution's management body and senior management as well as engagement with the institution for the assessment of material risk elements	Engagement with management body and senior management at least every three years

Quarterly

Every year — Every two years — Every three years

Key indicator monitoring

For all SREP elements …

1. Business model analysis
2. Internal governance and controls
3. Risks to capital
4. Risks to liquidity and funding

… requirement to quarterly analyse indicators, such as:

- CRR metrics, e.g. CET1 ratio, LCR, CVA
- Financial and risk indicators, e.g. RWA, EAD, EL, VaR
- Market based indicators, e.g. CDS, equityprices, interest rate curves
- Recovery plan indicators (BRRD)
- External data and macroeconomic indicators, e.g. GDP, unemployment, inflation

Indicators used for …

- Overall risk assessment
- Peer group analysis
- Time series analysis

… will impact

- SREP scores
- Supervisory planning
- Supervisory measures

Role of competent authorities

- Define the indicators and respective thresholds
- Establish escalation procedures in order to detect and investigate adverse developments
- Monitor development of indicators, also relative to peer group
- Evaluate the potential impact on the institution when indicators deteriorate
- Reassess the SREP score when indicators deteriorate

Results of key indicator monitoring are used for all SREP components and can trigger ad-hoc investigations

Core process: SREP elements

Sources of information for assessments should include amongst others:

- Strategic plans
- Financial reporting
- Regulatory reporting
- Internal reporting
- Recovery plans
- ICAAP
- ILAAP
- Third party reports, e.g. external audits
- Other studies, e.g. macroprudential reports

1. Business model analysis (BMA)

1. Preliminary assessment	• Identify main activities, product lines ,geographies, market positions • Identify the institution's peer group on the basis of the rival product/business lines targeting the same source of profits
2. Identification of the areas of focus for the BMA	• Identify the business lines which are most important for future business model sustainability and the ones most likely to increase vulnerabilities • Assess supervisory reviews and findings, internal and external audits, strategic plans and peer comparisons
3. Assessment of the business environment	• Develop an understanding of macroeconomic and market trends as well as strategic peer group intentions (analysis of competitive landscape)
4. Quantitative analysis of the current business model	• Analyse and assess the institution's profitability, balance sheet, concentrations and risk appetite taking the recent past and future trends into account
5. Qualitative analysis of the current business model	• Assess external and internal dependencies, reliance on reputation, strength of the relationships and areas of competitive advantage
6. Analysis of the strategy and financial plans	• Quantitative and qualitative analysis of strategic plans and projected financial performance, including the underlying success drivers and assumptions as well as execution capabilities
7. Assessment of the business model viability	• The institution's current business model's ability to generate acceptable returns over the following 12 months • Assess the acceptability of returns against ROE, funding structure, risk appetite
8. Assessment of the sustainability of the institution's strategy	• The sustainability of the institution's strategy on its ability to generate acceptable returns over the next three years • Assess the plausibility of assumptions and the risk level
9. Identification of key vulnerabilities	• Examples: unrealistic strategy, excessive concentrations or volatility, excessive risk taking, funding structure concerns and external issues

Scoring 1 – 4

2. Assessment of internal governance and controls

Overall internal governance framework	• Is the organisation fit for purpose? • Does the management know the institution's structure and risks? • Are adequate policies in place e.g. to avoid conflicts of interest, outsourcing?
Corporate and risk culture	• Has the institution a corporate and risk culture adequate for its business and risk appetite? • Are there independent whistle-blowing processes? • Is the culture clearly communicated across all levels?
Organisation and functioning of the management body	• Is the number of members of the management body adequate and do they demonstrate a sufficient level of commitment and independence? • Is the management body effective? • Adequacy of internal control procedures?
Risk management framework, including ICAAP & ILAAP	• Review an institution's ICAAP and ILAAP and determine their (1) soundness, (2) effectiveness and (3) comprehensiveness • Review of stress testing programs and determine the appropriateness of, e.g. scenarios, assumptions and methodologies
Internal control framework, including internal audit function	• Do independent control functions and clear decision making processes exist? • Are adequate risk reporting policies and compliance functions established, approved by the management body?
Information systems and business continuity	• Does accurate and reliable risk data exist (up-to-date, complete)? • Can on-demand data requests be met?
Remuneration policies and practices	• Is the remuneration policy in line with the risk profile, corporate values and risk appetite? • Ratio of variable and fixed remuneration is appropriate – are the provisions on the limitation of the variable component complied with?
Recovery plan arrangements	• Are adequate recovery plans available?

In addition, the following aspects are assessed on the consolidated level:

- Is the legal structure transparent?
- Does an institution-wide strategy and information system exist?
- Implementation of group policies on subsidiary level?

Scoring 1 – 4

3. Assessment of risks to capital

Measuring risk to capital

Credit and counterparty risk	Market risk	Operational risk	Interest Rate Risk in the Banking Book (IRRBB)

1. Assessment of materiality of risk
2. Evaluation of the nature, composition and sub-categories of risk categories
3. Evaluation of the accuracy and prudency of methodologies
4. For credit and counterparty risk, e.g. assessment of the quality of the credit portfolio, the applied credit risk mitigation techniques, the level of loan loss provisions and CVA
5. For market risk, e.g. evaluation of profitability and market concentration risk
6. For operational risk, e.g. assessment of the significance of operational risk exposures and reputational risk
7. For interest rate risk in the banking book, e.g. evaluation of scenario analysis and stress testing results

Assessment of risk management and controls

- Policies and procedures
- Risk identification and measurement
- Risk management, monitoring, reporting
- Organisational framework
- Internal control framework
- Respective risk strategy and appetite

Assessing whether own funds suffice to cover risks to capital

Capital requirements	Determining total SREP and overall capital requirements	Additional considerations
Overall capital requirements • CRD IV counter-cyclical buffer (0–2.5%) • CRD IV conservation buffer (2.5%) • Macro-prudential requirements (0–5%) **Total SREP capital requirements (TSCR)** • CRR own funds requirements (8%) • SREP additional own funds requirements	SREP own funds depend on the identified risks to capital while taking expected and unexpected losses over a one year horizon as well as model and governance deficiencies into account. SREP, CRD IV and macro-prudential buffers have to be reconciled to avoid double counting.	Excessive leveraging is assessed by • Comparing the leverage ratio to peers • Evaluating its distance to the regulatory minimum • Considering stressed events Analysis whether OCR and TSCR can be hold stable over the economic cycle and stress scenarios

Scoring 1 – 4

3. Assessment of risks to liquidity and funding

Risk to liquidity

Liquidity risks — Are liquidity buffers sufficient?

1. **Identify the short and medium term liquidity needs by:**
   - Calculating the liquidity needs and availability over different time horizons
   - Assessing if the LCR is appropriate and reflects the liquidity needs adequately
2. **Evaluate whether the liquidity buffer and counterbalancing capacity are sufficient to meet the liquidity needs by assessing:**
   - Volume of assets to be liquidated
   - Quality and classification of liquid assets, using the LCR specifications
   - Capability to sell liquid assets swiftly
3. **Conduct independent liquidity stress tests to assess liquidity needs and buffers**

Risk to funding

Funding profile and plan — Is funding stable & market access assured?

1. **Analyse the funding profile by evaluating:**
   - Sufficiency of stable funding instruments
   - Maturity mismatches
   - Whether the funding profile and level of asset encumbrance could increase funding costs
2. **Assess the stability of the funding profile, e.g.:**
   - Significance of certain asset classes
   - Funding metrics, e.g. loan/deposit ratio and NSFR
   - Concentration in funding sources
   - The impact of an increased demand for unsecured debt due to asset encumbrance
3. **Examine the current and future market access:**
   - The volume of funding demands on certain markets or counterparties compared to the capacities of these institutions
4. **Compare the funding risk to the funding plan**

Governance and risk management requirements

- Appropriate framework to identify, measure, manage, monitor and report risks
- Consistency between policies/procedures and the liquidity risk tolerance
- Adequate implementation of liquidity stress tests
- Integration into the overall risk strategy
- Effective internal limit and control system
- Adequate liquidity contingency plan
- Sufficient technical and human resources

Scoring 1 – 4

Overall assessment

Scale: 1 No risk identified — 2 Low level of risk — 3 Medium level of risk — 4 High level of risk — 5 Failing or likely to fail

Assessment is based on: Business model risk; Internal controls and governance; Capital resources; Liquidity resources; Risk management framework; Overall quantitative assessment; Interaction between these factors

Overall SREP score of 1 – 4 or F

- Score represents the institution's viability
- Overall score is not necessarily the simple average of the four scores
- Determination of the overall score at the discretion of the supervisory authorities

Early intervention and macro-prudential measures

Directive 2014/59/EU (Art. 27) defines early intervention tools, e.g.:

- Implementation of recovery plan measures
- Certain decisions to be approved by shareholders
- Replace members of the management body
- Restructuring of debt
- Change the business strategy

Macro-prudential measures

- Competent authorities are to assess whether the macroprudential measures adequately address the risks at the level of single institutions
- Competent authorities may extent macro-prudential measures on an institution-specific basis if measures are deemed inappropriate for the respective institution

Supplement supervisory measures

Supervisory measures

Directive 2013/36/EU (CRD IV, Art. 104 &105) defines the supervisory powers, e.g.:

- Determine additional own funds and liquidity requirements
- Increase governance, controls and involvement of the management body
- Curtail risk appetite and limits, e.g. modify the risk appetite, improve ICAAP, ILAAP, and stress testing procedures and models
- Require net profits to be used to increase own funds and prohibit dividend distribution to shareholders
- Enhance documentation, IT systems, reporting (including an increase in the reporting frequency)

Supervisory measures might be applied to all SREP components individually, examples include:

Business model	Internal governance & controls	Credit & counterparty risk	Operational risk	Market risk	IRRBB	Liquidity risk	Funding risk
Changes in the financial plan	Change governance and organisational structures or the structure and composition of the management body	Enhance collateral management, credit risk measurement and controls	Increase operational risk mitigation, e.g. through control points and insurance	Restrict or reduce investments in certain products	Demand different internal limits	Change the composition of liquid assets and introduce caps, limits or restriction on funding concentrations	Reduce dependency on certain funding markets

Deloitte.