

Supervisory Review and Evaluation Process (SREP)

Single Supervisory Mechanism

Index

- ➔ • Overview
- Regulatory and supervisory framework
- Supervisory Review and Evaluation Process (SREP)
- Annex

Overview

The ECB has developed a common methodology for the Supervisory Review and Evaluation Process (SREP) to which financial institutions will have to adapt

The ECB took over as **supervisor of financial institutions in the Eurozone** in November 2014, as part of the Single Supervisory Mechanism (SSM).

The SSM is responsible for the prudential supervision of all credit institutions within the participating Member States. It guarantees that the EU prudential supervision policy is applied consistently and efficiently across all credit institution. It also ensures that these institutions are subject to a high quality supervision.

The **three main objectives** of the SSM are to:

1. Ensure the safety and soundness of the European banking system.
2. Increase financial integration and stability.
3. Ensure consistent supervision.

In order to accomplish these objectives, the ECB is developing rules, procedures and methodologies that will constitute the institutions' supervisory tools. Specifically, the ECB has developed a common methodology for the development of the Supervisory Review and Evaluation Process (SREP), through which the systems, strategies, processes and mechanisms implemented by entities will be reviewed.

Index

- Overview
- ➔ • Regulatory and supervisory framework
- Supervisory Review and Evaluation Process (SREP)
- Annex

Regulatory and supervisory framework

Supervisory principles

The ECB has adopted 9 supervisory principles which serve as the basis for its supervisory activity within the SSM framework and are critical for the effective functioning of the system

Supervisory principles

1	Use of best practices	The SSM aspires to be a best practice framework , in terms of objectives, instruments, and powers used.
2	Integrity and decentralization	The SSM draws on the expertise and resources of NCAs in performing its supervisory tasks, thereby ensuring consistent supervisory results.
3	Homogeneity within the SSM	Supervisory principles and procedures are applied to credit institutions across all participating Member States in an appropriately harmonised way
4	Consistency with the Single Market	The SSM complies with the single rulebook and is fully open to all EU Member States whose currency is not the euro and who have decided to enter into close cooperation.
5	Independence and accountability	The supervisory tasks are exercised in an independent manner . Supervision is also subject to high standards of democratic accountability .
6	Risk-based approach	The SSM takes into account both the degree of damage which the failure of an institution could cause to financial stability and the possibility of such a failure occurring.
7	Proportionality	The supervisory practices of the SSM are commensurate with the systemic importance and risk profile of the credit institutions under supervision.
8	Adequate levels of supervisory activity for all credit institutions	The SSM adopts minimum levels of supervisory activity for all credit institutions and ensures that there is an adequate level of engagement with all significant institutions.
9	Effective and timely corrective measures	The SSM's supervisory approach fosters timely supervisory action and a thorough monitoring of a credit institution's response.

Regulatory and supervisory framework

The functioning of the SSM: Supervision and governance

The ECB directly supervises significant institutions and the NCAs conduct the supervision of less significant entities. Moreover, the governance framework and the decision-making process within the SSM have been defined

Supervision and governance



(1) • Assets > 30 bn€ or > 20 % of national GDP (if assets >5 bn€) or
• It is 1 of the 3 most significant credit institutions in a Member State or
• It is a recipient of direct assistance from the European Stability Mechanism or

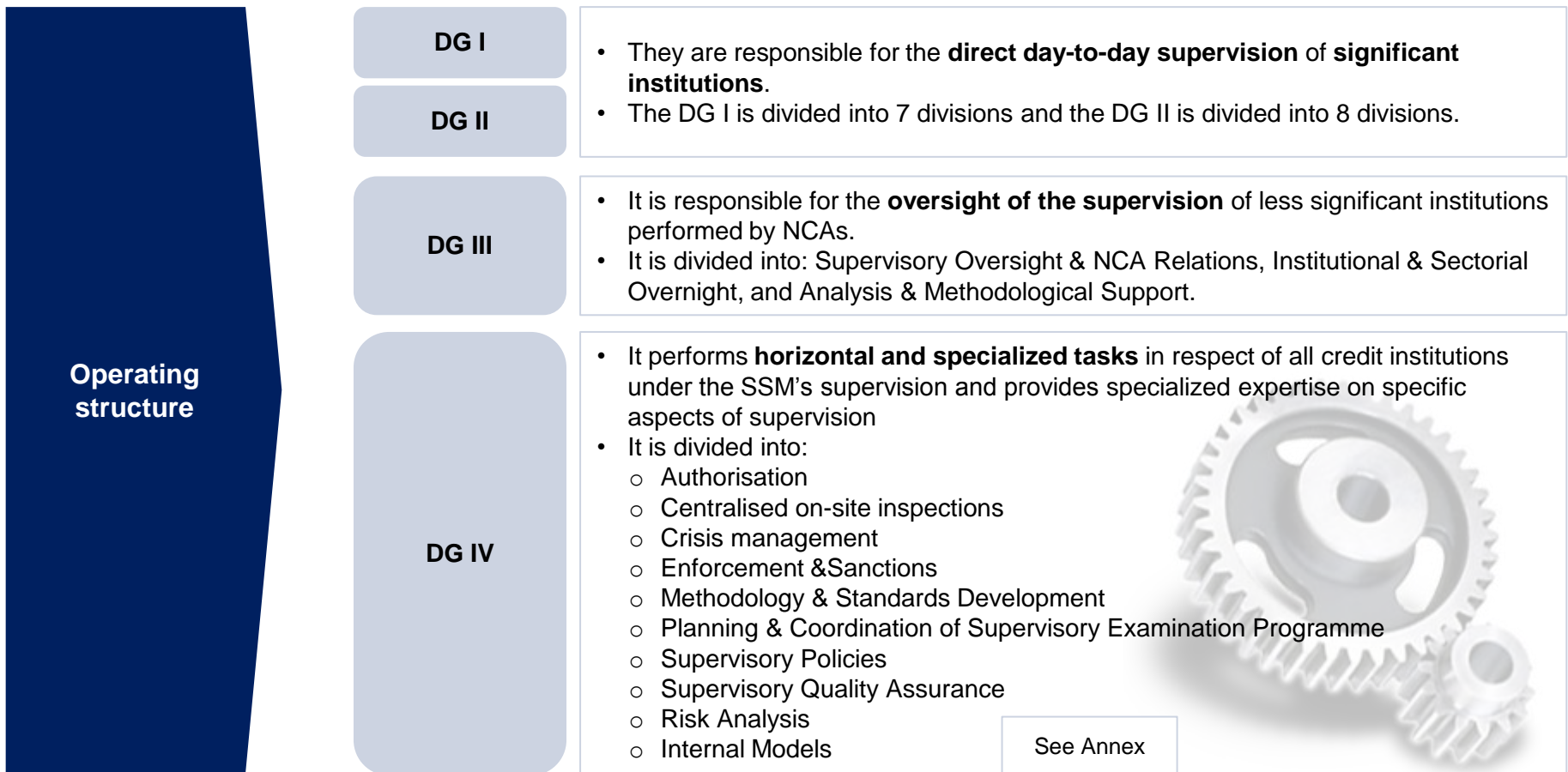
• Assets >5 bn€ and cross-border assets liabilities/ in more than other participating Member State to its total assets/liabilities is above 20 %.

Regulatory and supervisory framework

The functioning of the SSM: Operating structure

The ECB has established four dedicated Directorates General (DGs) to perform the supervisory tasks conferred on the ECB in cooperation with NCAs

Operating structure



Regulatory and supervisory framework

The functioning of the SSM: the supervisory cycle

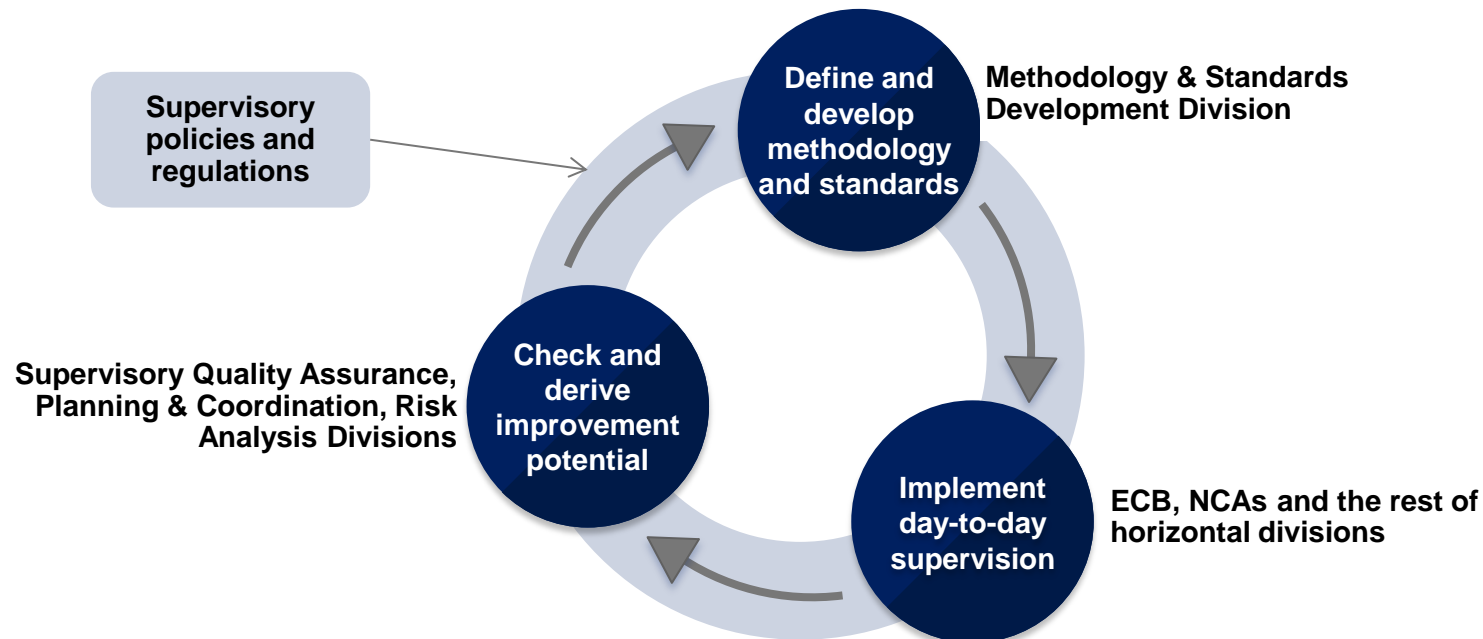
The process for the supervision can be envisaged as a cycle consisting of the following parts:
definition and development of methodologies and standards, day-to-day supervision,
and checking and improvement potential

Supervisory cycle

Definition

The process for the supervision of credit institutions can be envisaged as a cycle:

- Regulation and supervisory policies provide the foundation for supervisory activities and for the development of supervisory **methodologies and standards**.
- The methodologies and standards underpin the **day-to-day supervision**.
- The lessons learnt in the course of supervision and the performance of quality assurance checks feed back into the definition of **methodologies, standards, supervisory policies and regulation**.



Index

- Overview
- Regulatory and supervisory framework
- ➡ • Supervisory Review and Evaluation Process (SREP)
- Annex

Supervisory Review and Evaluation Process (SREP)

SREP definition and structure

Within the definition and structure, the SSM has defined a common methodology to carry out the Supervisory Review and Evaluation Process (SREP)

SREP Definition and structure

Definition

- The SREP empowers competent authorities to review the **arrangements, strategies, processes** and **mechanisms** implemented by institutions and to assess the specific risks that financial institutions are exposed to, the risks of emerging threats to the financial stability and the risks revealed by stress tests.
- The **SSM has developed its own SREP**, complying with the EBA guidelines, which in the first instance will be applied to significant institutions.

SREP structure

Areas

1. Business model assessment

2. Governance and risk management assessment

3. Risk-by-risk capital assessment

4. Liquidity assessment

Tools

- A RAS¹ is used for evaluating each of the areas comprising the SREP.
- Additionally, capital will be assessed through an ICAAP and a stressed ICAAP.
- Liquidity will be assessed through an ILAAP.

Overall SREP assessment

- Each area within the SREP receives a particular rating.
- These ratings will result in an overall SREP assessment, consisting on a score from 1 to 4.
- Depending on the overall SREP assessment, supervisors may impose supervisory measures:
 - Quantitative capital measures
 - Quantitative liquidity measures
 - Other measures

1. Risk Assessment System

Supervisory Review and Evaluation Process (SREP)

SREP assessment

Following discussions with clients, it has been deduced that the SREP will consist, subject to further modifications, on a overall rating (from 1 to 4¹) comprising the individual scores for capital related risks, as well as the scores from the capital and liquidity assessments

SREP assessment

SREP assessment

- Capital related **risks** score
- **Capital** adequacy assessment
- **Liquidity** adequacy assessment
- **Internal governance** and **risk management** assessment
- **Business model** and **profitability** assessment

SREP Rating

Example

Capital related risks score	Combined assessment
Credit risk	4
Market risk	2
Interest rate risk in the banking book	3
Operational risk	3
Capital related risks score	3
Capital adequacy assessment	2
Liquidity risk and adequacy assessment	2
Internal governance and risk management assessment	2
Business model risk and profitably assessment	3
Average as indication for overall SREP	2,3
Overall SREP rating	3

Floor for overall SREP rating

Supervisory Review and Evaluation Process (SREP)

Information sources

The supervisory assessment will be based on quantitative and qualitative information that the supervisor will use in the SREP exercise

Information sources required by supervisors

Quantitative information

1. **Key Risk Indicators** based on Finrep and Corep
2. **Key Risk Indicators** from different data sources than Finrep/Corep
3. **Operating environment indicators** (GDP, sectorial NPL, market volatility...)
4. **Other indicators based on non-regular reporting data** (important for supervisory benchmark quantification and related indicators)
5. **Other regulatory data not harmonized** (central credit register...)
6. **Bank internal estimates** (ICAAP, ILAAP, stress tests, internal reports)
7. **Financial statements**, Pillar 3
8. **Peer group indicators** of the above (general dimension in information)
9. **Stress test results** performed by JST together with MS IV
10. **Market views** (equity analyst recommendations, credit rating changes...)

Qualitative information

1. **Supervisory findings** (inspections reports, meeting reports...)
2. **Bank internal documents** (ICAAP/ILAAP, financial statements, board memos, organizational charts, internal audit reports, whistle-blower reports)
3. **Operating environment reports** (risk trends, new focus themes)
4. **Business and risk management** reports (dashboards, limit reports...)
5. **Third party reports** (analyst reports, rating agency reports, news...)



Supervisory Review and Evaluation Process (SREP)

Risk Assessment System (RAS)

The Risk Assessment System (RAS) assesses the risk level and risk control for each risk category in order to obtain an overall rating that will be used in the SREP

Risk Assessment System (RAS)

Concept

System used to regularly assess banks' risk level and risk control.

- **Objective:** to identify the weaknesses regarding risk position and risk management, as well as to capture the assessment in a consistent and comparable way.
- **Output:** a risk analysis, as well as short narratives summarised in scores, and internal communication.

RAS process

- The RAS, performed for each risk category, is carried out at two **different levels**:
 - The **risk level assessment** consists of the following parts: gathering of information, automated anchoring rating and the main assessment of the risk level.
 - The **risk control** is comprised of the following phases: the data gathering-phase, the compliance-checking phase and the main assessment phase.
- After the RAS process is completed an **overall rating** (from 1 to 4)¹ is obtained for each risk category and level.
- Afterwards, the **combined rating** shall be calculated.



Assessed risk categories:

- Business model risk and profitability risk
- Internal governance and risk management
- Credit risk
- Market risk
- Operational risk
- Interest rate risk in the banking book
- Capital adequacy anchoring rating and on-going adequacy assessment
- Liquidity and funding risk position
- Insurance risk and others

1. With 1 being the best possible score and 4 the worst.

Supervisory Review and Evaluation Process (SREP)

Risk Assessment System (RAS)

Following discussions with clients, it has been deduced that the RAS score will be based on the current risk position (KRIs), the stress test results and the opportunities within the operating environment perspective

Examples for assigning rating

Score	Evidence
1	<ul style="list-style-type: none"> Current risk position (e.g. KRIs) is at very satisfactory levels in absolute and relative terms (peers). Forward-looking assessment (e.g. stress tests) shows absence of threat. Operating environment perspective (macro indicators, and/or regulatory environment) point to strong opportunities.
2	<ul style="list-style-type: none"> Current risk position (KRIs) is at satisfactory levels in absolute terms – albeit below best group of peers. Forward-looking assessment (stress tests) shows limited risk. Operating environment perspective (macro indicators, perspective and/or regulatory environment) shows limited opportunities.
3	<ul style="list-style-type: none"> Current risk position (KRIs) is at non-satisfactory levels in absolute and relative terms (peers). Forward-looking assessment (stress tests) are point to serious risk. Operating environment perspective (macro indicators, perspective and/or regulatory environment) are an issue.
4	<ul style="list-style-type: none"> Current risk position (KRIs) is at historic levels in absolute and relative terms (peers). Forward-looking assessment (stress tests) point to severe risk. Operating environment perspective (macro indicators, perspective and/or regulatory environment) are negative.

Supervisory Review and Evaluation Process (SREP)

Detail: capital and liquidity quantification

Capital requirements quantification is based on the ICAAP assessment and the development of stress tests; the liquidity requirements quantification is based on the ILAAP assessment

Capital and liquidity quantification

Definition

Capital and liquidity are quantified by using the resulting information of the RAS and the ICAAP/ILAAP. A comprehensive evaluation of the ICAAP/ILAAP is carried out, along with a comparison of the former with the capital and liquidity needs established by the SSM, also under stress conditions.

- **Results:** monetary units or ratios (ex. CET1 SREP ratio)

Capital requirements

- NCAs will have to evaluate and assign a score to each **identified material risk**.
- NCAs will have to **calculate total capital requirements** as the sum of the own funds requirement in the CRR and the sum of the additional own funds requirement.
- The main source to calculate the requirements will be the **ICAAP**.

Own funds evaluation

- NCAs will determine whether an entity has **sufficient own funds** to cover all identified risks.
- NCAs will use stress tests to determine the impact of adverse scenarios on own funds.
- They will also assign a **score** depending on the capability of own funds to cover risks.

Liquidity requirements

The evaluation will use the entity's **ILAAP** as primary source of information.

The evaluation will include:

- Liquidity buffers.
- Compensation capability and **financial profile**.
- **Policies, processes and mechanisms** to measure and manage liquidity risk and financing risk

Index

- Overview
- Regulatory and supervisory framework
- Supervisory Review and Evaluation Process (SREP)

- ➔ • Annex

Annex 1

Supervision of significant institutions

The ECB carries out tasks related to planning of supervisory activities, assessment of suitability of management bodies, crisis management, on-site inspections, supervisory measures and powers, and sanctions

Supervision of significant institutions

Tasks carried out by the ECB in relation to significant institutions

- **Planning of supervisory activities:** decided through a two-step process: strategic planning and operational planning.
- **Assessment of the suitability of members of management bodies:** changes to the composition of the management body of a significant institution are declared to the relevant NCA, which then informs the relevant JST and the ECB's Authorization Division. The change is proposed to the Supervisory Board and Governing Council.
- **Crisis management:** the ECB will be enabled to react in a timely manner if a credit institution does not meet, or is likely to breach, the requirements of CRD IV and will ensure that credit institutions establish reliable recovery plans. With regard to resolution planning, the SSM has a consultative role.
- **On-site inspections:** of risks, risk controls and governance with a pre-defined scope and time frame at the premises of a credit institution. Ad hoc inspections may be conducted in response to an event or incident which has emerged at a credit institution.
- **Use of supervisory measures and powers:** the ECB is empowered to require significant credit institutions to take steps at an early stage to address problems regarding compliance with prudential requirements.
- **Enforcement and sanctions:**
 - If regulatory requirements have been breached, the supervisor may impose sanctions of up to twice the amount of the profits gained or losses avoided because of the breach where those can be determined, or up to 10% of the total annual turnover in the preceding business year.
 - In the case of a breach of a supervisory decision or regulation of the ECB, the ECB may impose a periodic penalty payment with a view to compelling the persons concerned to comply with the prior supervisory decision or regulation. This penalty will be imposed for a period no longer than 6 months.



Annex 2

Supervision of less significant institutions

Although the NCAs are responsible for the direct supervision of less significant institutions, the ECB carries out the information gathering, oversight activities and has certain intervention powers

Supervision of less significant institutions

Tasks carried out by the ECB in relation to less significant institutions

- **Information gathering:** ECB regularly receives quantitative and qualitative information on the less significant institutions, which is used to identify particular risks in individual institutions and to perform a sector-wide analysis.
- **Oversight activities:**
 - The ECB reviews the format in which NCAs apply material draft supervisory decisions and procedures within the SSM.
 - It can also recommend changes to areas where further harmonisation is needed and, where appropriate, may also develop standards as regards supervisory practices.
- **Intervention powers of the ECB:** the ECB, in cooperation with the NCAs, determines regularly whether an institution changes its status from “less significant” to “significant” by fulfilling any of the criteria established in the SSM Regulation.
 - The ECB may also at any time on its own initiative, after consulting with the NCAs, decide to directly exercise supervision on less significant institutions, when necessary, to ensure consistent application of high supervisory standards.
 - The deterioration of a less significant institution’s financial condition or the initiation of crisis management proceedings are not necessarily reasons for the ECB to take over supervision.



Annex 3

DG IV: activities conducted

The DG IV performs horizontal and specialized tasks in respect of all credit institutions under the SSM's supervision and provides specialised expertise

DG IV: activities conducted

- Authorisation division: it has the power to grant and withdraw the authorisation of any credit institution and to assess the acquisition of holdings in credit institutions in the euro area.
- Centralised on-site inspections division: it is responsible for planning the on-site inspections on a yearly basis.
- Crisis management division: it supports the JSTs in times of crisis. Moreover, it reviews the significant supervised credit institutions' recovery plans and conducts further analysis. It also will participate in Crisis Management Groups.
- Enforcement & sanctions division: it investigates alleged breaches by credit institutions of directly applicable EU Law, national law transposing EU directives or ECB regulations and decisions.
- Methodology & standards development division: it regularly reviews and develops supervisory methodology, given that it may evolve from work by international standard-setting bodies.
- Planning & coordination of supervisory examination programme division: it is responsible for the strategic planning, which encompasses the definition of the strategic priorities and the focus of the supervisory work for the following 12 to 18 months.
- Supervisory policies division: it assists in developing statutory prudential requirements for significant and less significant banks. Moreover, it coordinates the SSM's international cooperation and supports the JSTs' work in the College of Supervisors by setting up and updating cooperation agreements.
- Supervisory quality assurance division: it is responsible for the horizontal quality control of the JSTs.
- Risk analysis division: as a natural complement to the JST's day-to-day analysis of a credit institutions' risks, it analyses risks horizontally.
- Internal models division: it supports JSTs when checking if a significant institution complies with the legal requirements and the relevant EBA Guidelines in the internal models approval process.

