



EUROPEAN CENTRAL BANK

BANKING SUPERVISION

SSM SREP Methodology Booklet

Level Playing Field - High Standards of Supervision - Sound Risk Assessment

- ✓ **Level playing field** : SREP for the **first time** carried out for Significant Institutions according to:
 - a **common methodology**
 - a **common decision-making process** allowing for peer comparisons and transversal analyses on a wide scale

- ✓ **High standards of supervision**
 - Follow the **EBA guidelines on SREP** and draw on leading practices within the SSM and as recommended by **international bodies**
 - **Proportionality, flexibility and continuous improvement**
 - **Supervisory decisions - not only additional capital requirements but also additional measures** tailored to banks' specific weaknesses

- ✓ **Sound risk assessment**
 - **Combination of quantitative and qualitative elements**
 - **Holistic assessment of institutions' viability** taking into account their specificities
 - **Forward-looking perspective**

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1. Legal Basis

The SSM methodology implements Union law, EBA Guidelines and supervisory best practices

SREP in CRD IV - Article 97

...the competent authorities shall review the arrangements, strategies, processes and mechanisms implemented by the institutions and evaluate:

- (a) risks to which the institutions are or might be exposed;*
- (b) risks that an institution poses to the financial system and*
- (c) risks revealed by stress testing taking into account the nature, scale and complexity of an institution's activities.*



RTS, ITS and EBA Guidelines

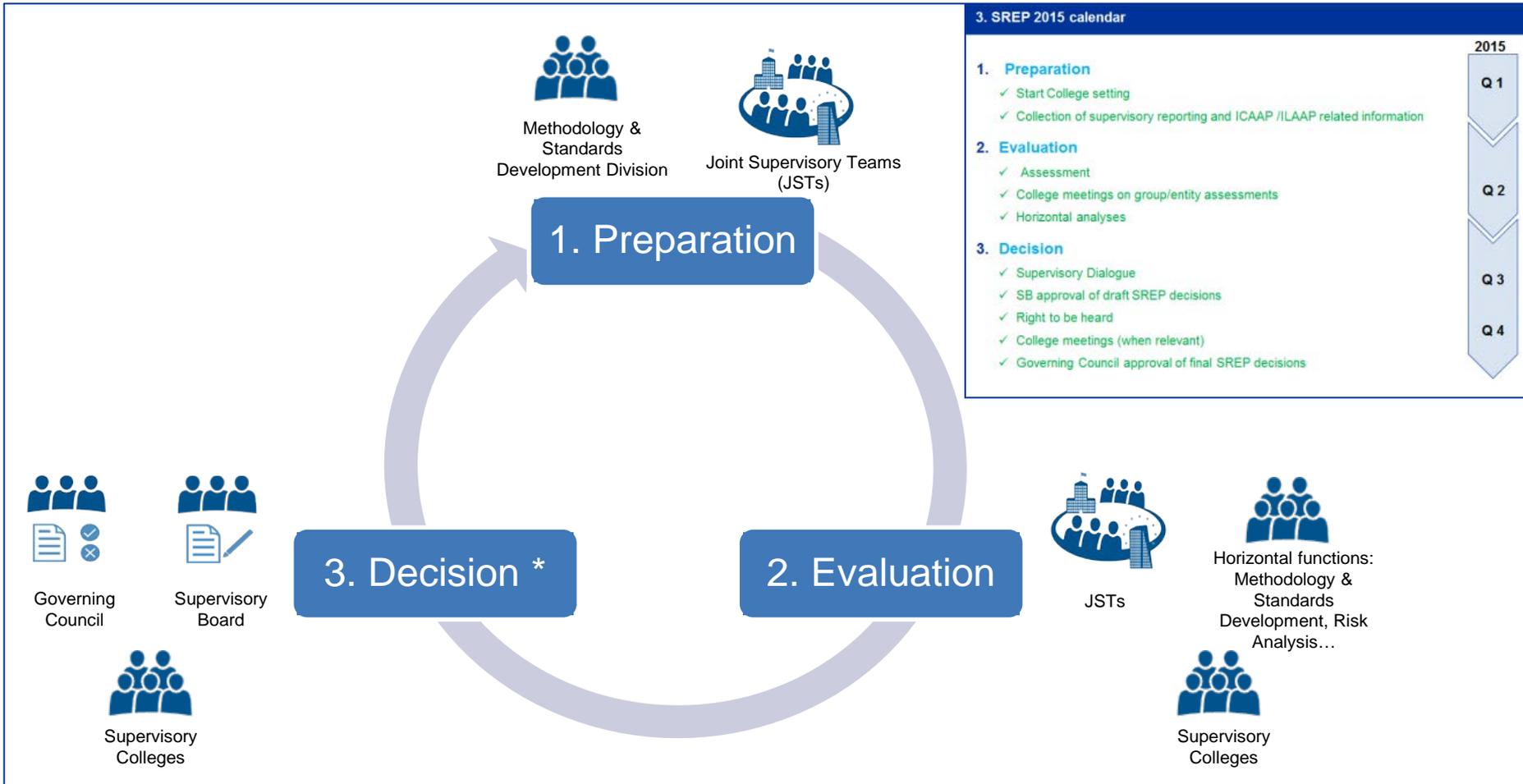
- *Implementing Technical Standards (ITS) on joint decisions on prudential requirements*
- *Regulatory Technical Standards (RTS) and ITS on the functioning of colleges of supervisors*
- *Guidelines on common procedures and methodologies for the SREP (EBA/GL/2014/13) - 19 December 2014*



BCBS and FSB Principles



Supervisors at ECB and in 19 countries jointly prepared SREP decisions for SSM Significant Institutions through a common process for the first time



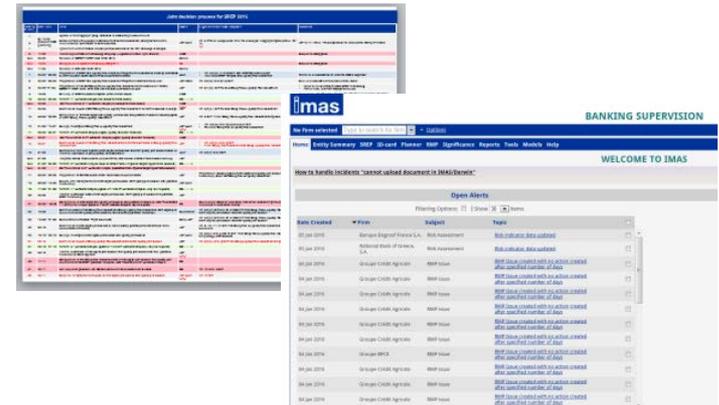
* Note: decision finalised after right-to-be-heard procedure and Governing Council non-objection.

Underlying infrastructure built in less than one year

- Common integrated IT system
- Secured Information flow between all supervisors
- Bank data quality controls at 2 levels: NCAs and ECB
- Full use of NCA and ECB resources
- In-depth field testing of the methodology in H2 2014 – Q1 2015

SREP managed as a key project

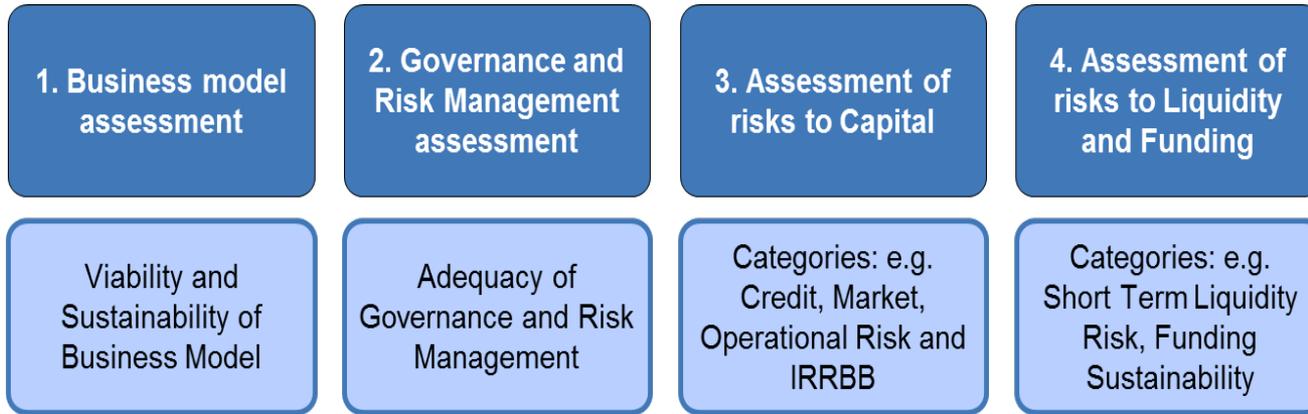
- Common timeline
- Steering by Senior Management
- Project management, methodology development and horizontal consistency ensured by the ECB's DG MS IV
- Full use of ECB and NCA expertise - especially in methodology development - through thematic workshops and dedicated Q&A sessions delivered by DG MS IV



➡ Execution **fully in line** with plan
➡ SREP completed in IT system

Building block approach in line with EBA Guidelines

SREP methodology at a glance: four key elements



Overall SREP assessment – Holistic approach

→ Score + Rationale/main conclusions

SREP Decision

Quantitative capital measures

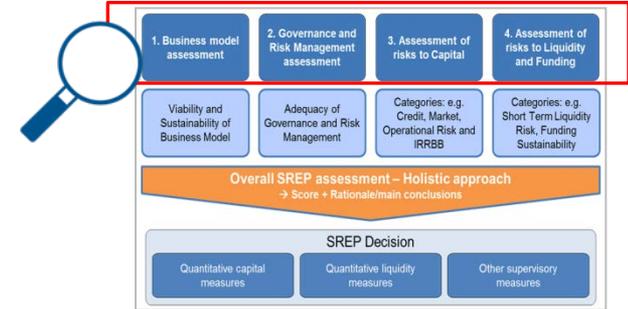
Quantitative liquidity measures

Other supervisory measures



Feeds into the Supervisory Examination Programme (SEP)

All four SREP elements follow a common logic ensuring a sound risk assessment



Three phases in on-going risk assessment for each of four elements

Phase 1 Data gathering	Phase 2 Automated anchoring score	Phase 3 Supervisory Judgement
<p>Main sources:</p> <ul style="list-style-type: none"> • quarterly ITS • STE reports 	<ul style="list-style-type: none"> • Scoring Risk Level • Formal compliance checking of Risk Control 	<p>Adjustments based on additional factors and considering banks' specificities and complexity</p>

Risk Level (RL) vs. Risk Control (RC)

	1. Business model	2. Internal Governance and RM	3. Assessment of Capital risks	4. Assessment of Liquidity risks
RL	✓	n/a	✓	✓
RC	n/a	✓	✓	✓

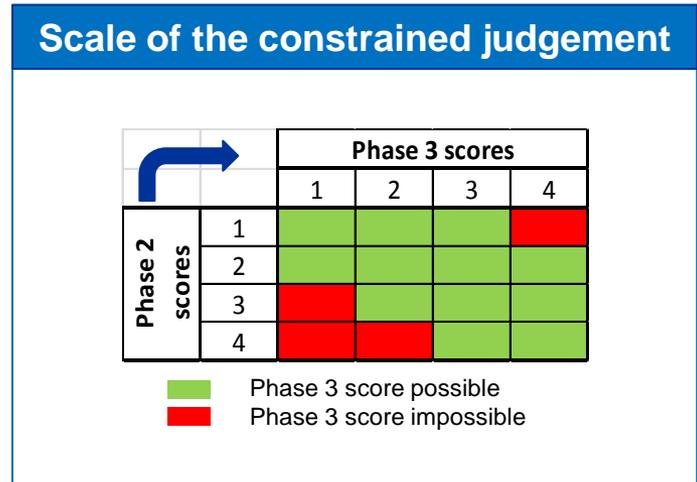
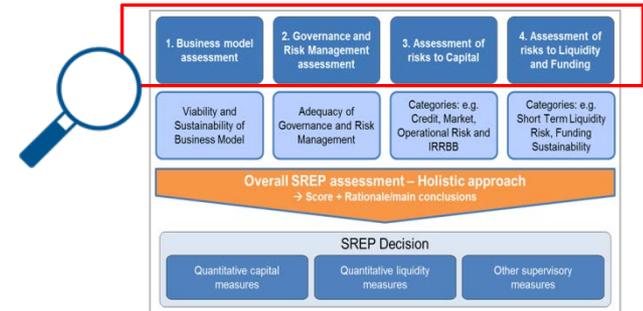
Combined score (RL + RC)

n/a: not applicable

The intensity of the supervisory engagement is decided based on banks' risk profile and size.

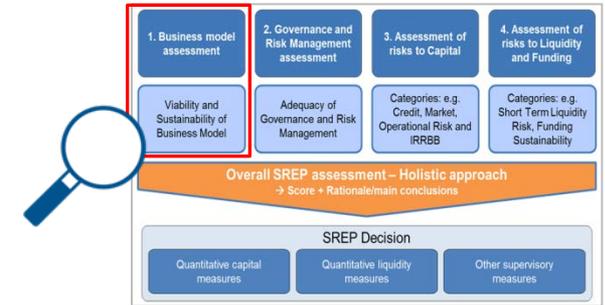
Constrained judgement

- Fair flexibility in a four-grade scale where Phase 2 score can be improved by one notch and worsened by two notches based on supervisory judgment
- Ensures the right balance between:
 - a common process, ensuring consistency across the SSM banks and defining an anchor point,
 - and the necessary supervisory judgment, to take into account the specificities and complexity of an institution.
- Adjustments go in both directions and are fully documented by the JST in the integrated IT system
- Departing from constrained judgement not allowed as a rule
- Constrained judgment **effectively** used by JSTs for **all** risk categories **in both directions**: improving as well as worsening Phase 2 scores



Business Model

- Identification of the areas of focus (e.g. main activities)
- Assessment of the business environment
- Analysis of the forward looking strategy and financial plans
- Assessment of the business model:
 - viability (within 1 year)
 - sustainability (within 3 years)
 - sustainability over the cycle (more than 3 years)
- Assessment of the key vulnerabilities



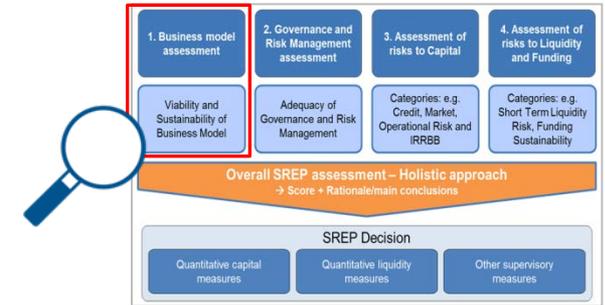
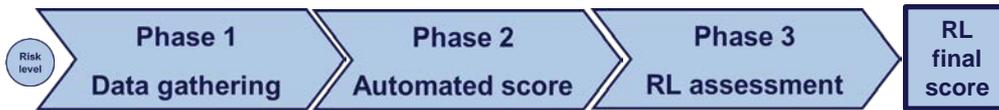
Examples of identified Business Models

- Custodian
- Diversified lender
- Retail lender
- Small universal bank
- Specialised lender
- Universal bank



In line with EBA SREP
Guidelines, § 55-57

Business Model



Phase 1

- **Information gathering and understanding materiality of business areas**

Phase 2

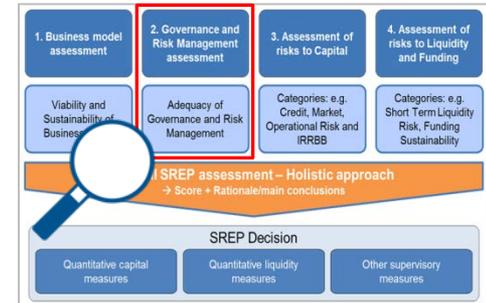
- **Automated anchoring score based on indicators, such as ROA, Cost Income ratio...**

Phase 3

- **Comprehensive analysis**
- **Used to adjust phase 2 score taking into consideration the bank's specificities**

Internal Governance & Risk Management

- Internal governance framework (including key control functions such as risk management, internal auditing, compliance)
- Risk management framework and risk culture
- Risk infrastructure, internal data and reporting
- Remuneration policies and practices



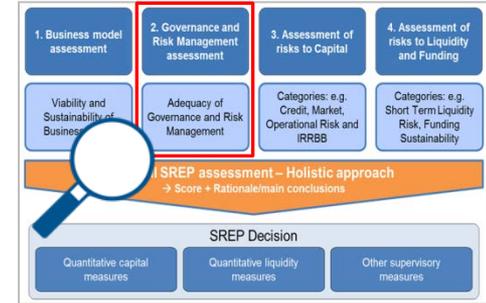
Two examples of Key Questions

- Is there a compliance function in place that is hierarchically and functionally separate and operationally independent from any business activity responsibilities?
- Are there mechanisms in place to ensure that senior management can act in a timely manner to effectively manage, and where necessary mitigate, material adverse risk exposures, in particular those that are close to or exceed the approved risk appetite statement or risk limits?



In line with EBA SREP Guidelines, § 81-82

Internal Governance & Risk Management



Phase 1

- **Information gathering e.g. through the thematic review on internal governance**

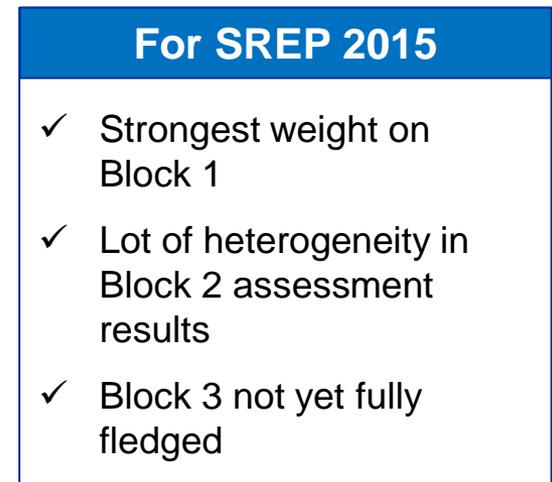
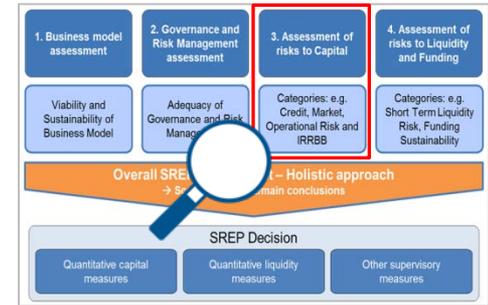
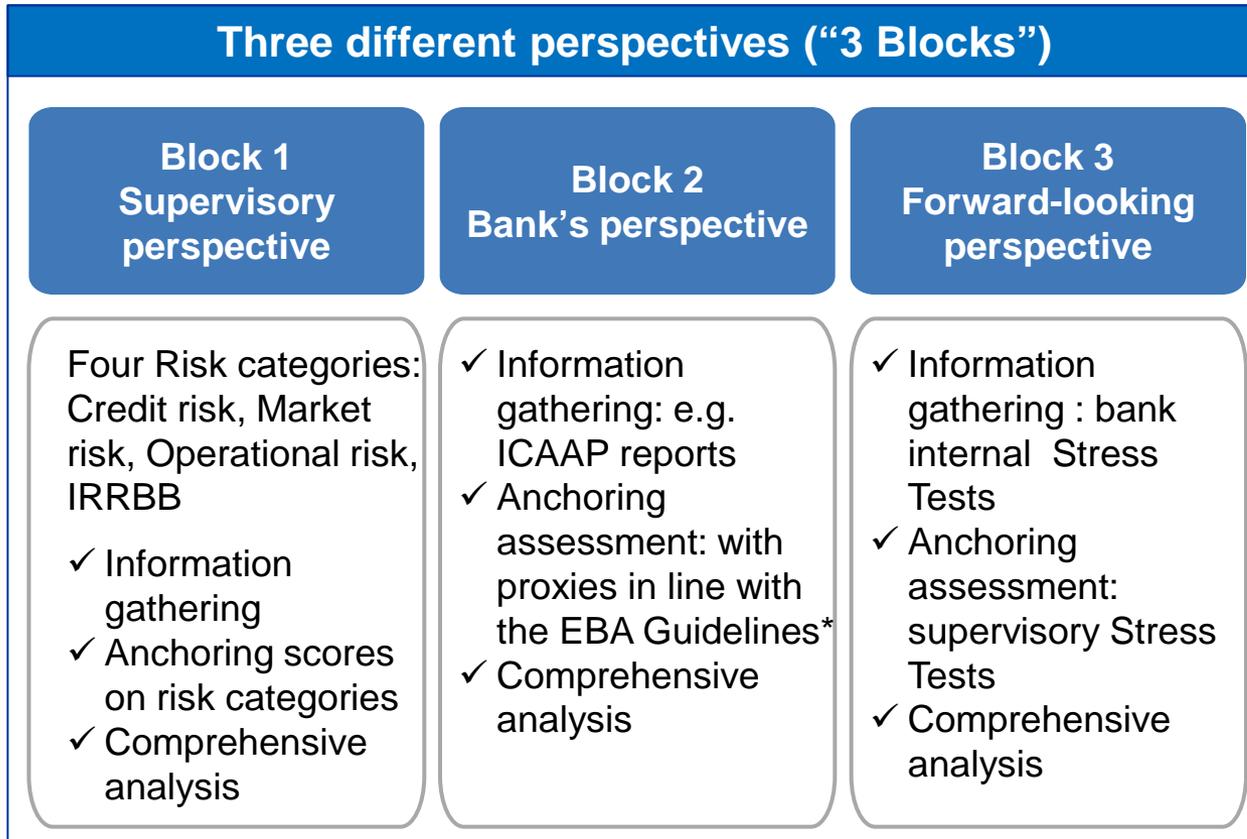
Phase 2

- **Check compliance with CRD provisions**
- **Specific analysis of e.g:**
 - organisational structure,
 - internal audit,
 - compliance,
 - remuneration,
 - risk appetite,
 - risk infrastructure,
 - reporting...

Phase 3

- **Comprehensive analysis**
- **Used to adjust phase 2 check taking into consideration the bank's specificities**

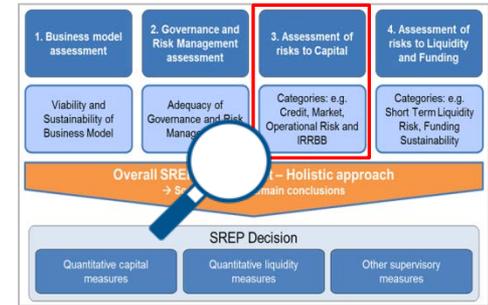
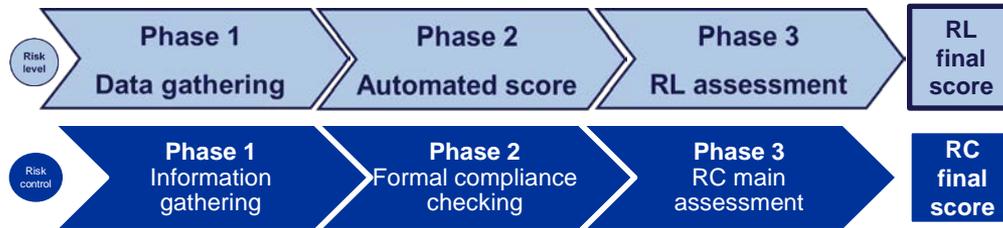
Risks to Capital



In line with EBA SREP Guidelines

* SSM proxies implement the concept of supervisory benchmarks set out in the EBA Guidelines on SREP (§ 335)

Risks to Capital - Block 1



➔ Deep-dive into a given risk factor: **credit risk** (example)

Phase 1

- **Risk Level:**
 - Sub-set of pre-defined indicators calculated from ITS and STE data
- **Risk Control:**
 - Information gathering

Phase 2

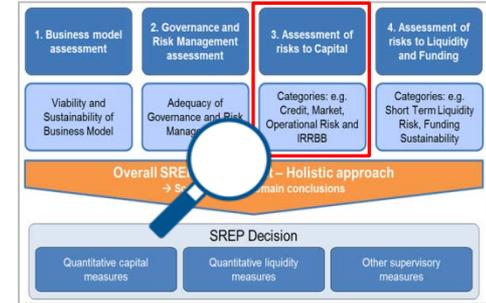
- **Risk Level:**
 - Automated score given through different dimensions, such as:
 - Quality (e.g. non performing loans ratio)
 - Coverage (e.g. provisions)
- **Risk Control:**
 - Compliance checks relating to internal governance, risk appetite, risk management and internal audit of credit risk in particular

Phase 3

- **Risk Level:**
 - **Comprehensive analysis, e.g.:**
 - Current risk position and trend
 - Forward looking view
 - Peer comparison
 - **In-depth analysis of various sub-categories, e.g.:**
 - Non-financial corporate portfolios or
 - Household portfolios
- **Risk Control:**
 - Deeper analysis, notably thanks to dedicated meetings with the bank

Risks to Capital - Block 2

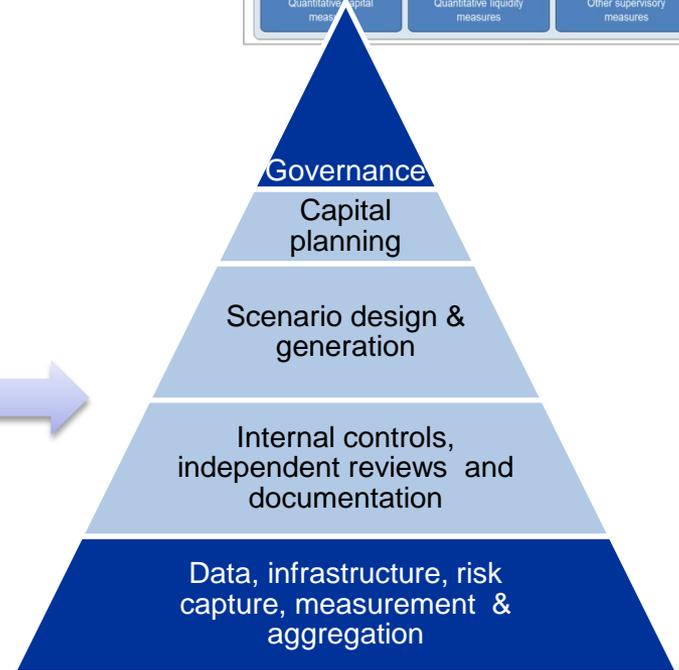
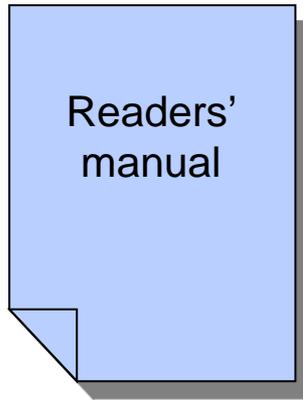
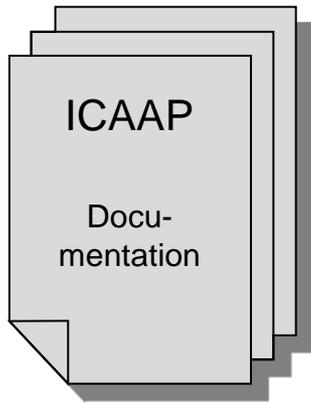
- ICAAP reliability assessment
- Following ECB ICAAP expectations published on 08.01.2016, JSTs:
 - assess reliability of the whole process - *qualitative assessment*
 - challenge ICAAP figures with SSM proxies - *quantitative assessment*
 - come up with block 2 assessment to feed the overall capital adequacy assessment



ECB ICAAP expectations

- Content as described in EBA draft Guidelines to be delivered by end of April 2016 with reference date end 31.12.2015
- Internal documentation together with a “readers manual”
- Risk data template
- Reconciliation between Pillar 1 and ICAAP figures
- Conclusions in form of capital adequacy statements supported by analysis of ICAAP outcomes and signed by management body

ICAAP - Qualitative assessment



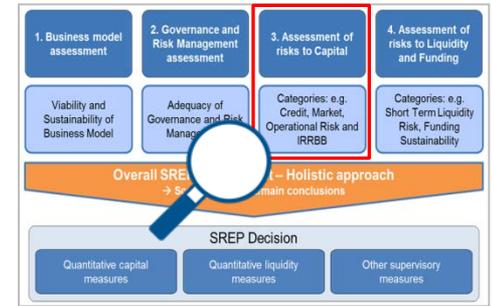
JST assessment

→ ICAAP reliable? (yes/no)

Bank-internal documents as set out in EBA GL

Mapped to EBA GL structure to facilitate JST access to bank-internal information

ICAAP - Quantitative assessment



ICAAP risk data

Risk definition and ICAAP estimates according to banks own risk taxonomy

Mapping of internal risk categories to SSM risk map and information on internal capital

Please provide the information and data only as internally available. Do not change or produce internal numbers only for filling columns 1-5 of the template. If the cell is not applicable to the institution, please complete as "na" for not applicable. Only white cells can be filled in.

SSM Risk Map		ICAAP Information				
1.1 Risk categories	1.2 Risk sub-categories (where applicable)	1.3 Name of internal risk category as currently covered in ICAAP (please use available internal and external risk categories as possible for sub-categories as possible for risk categories of sub-categories not covered in SSM risk map please use internal name)	1.4 Short description of internal risk category (including sub-categories that are included)	1.5 ICAAP estimate - internal capital needed (in value) in CET1 (please only provide numbers as internally available)	1.6 How have been material changes in scope or quantification methodology for this risk category / sub-category since the last reporting date? (Y/N)	1.7 PI risk to be used in the SREP
Credit risk						
	credit risk (please use the same name as sub-categories are specified in table 1.1 or separate sub-categories are available)					
	default risk					
	credit concentration risk					
	PI lending risk					
	Operational risk					
	Country risk (including transfer of assets)					
	settlement and delivery risk					
	residual risk					
	liquidity risk					

Proxies*

- Give rough quantification of capital demand
- Allow JST to put institution's estimates in perspective and underpin supervisory dialogue
- Do not provide a single risk figure, but indicative ranges for JSTs to derive risk-by-risk capital figures based on their judgement

* Concentration risk (single name and sectorial), Market risk. Credit risk, IRRBB

Assessment

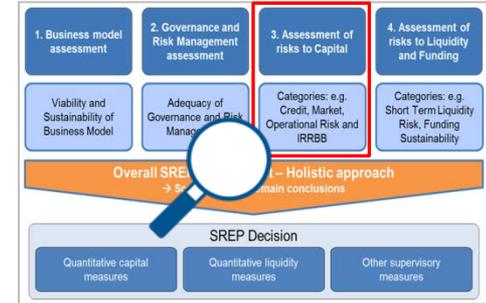
Internal capital adjusted figure (capital requirements)

- Pillar 1 as floor
- No inter-risk diversification

Dialogue with Banks

Risks to Capital - Block 3

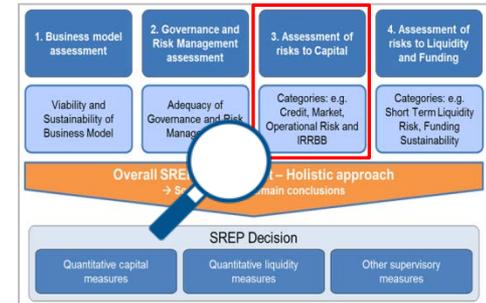
- Forward-looking perspective
- In 2016, two large-scale stress test exercises currently under preparation



Characteristics	EBA EU-wide Stress Test	SREP Stress Test
Scope	<ul style="list-style-type: none"> • 38 SSM SIs 	<ul style="list-style-type: none"> • Remaining SIs* <i>* Exceptions may apply - preparation work in progress</i>
Timeline	<ul style="list-style-type: none"> • Launch of the exercise: end of February 2016 • Publication: beginning of Q3 2016 	<ul style="list-style-type: none"> • Broadly aligned with the EBA Stress Test

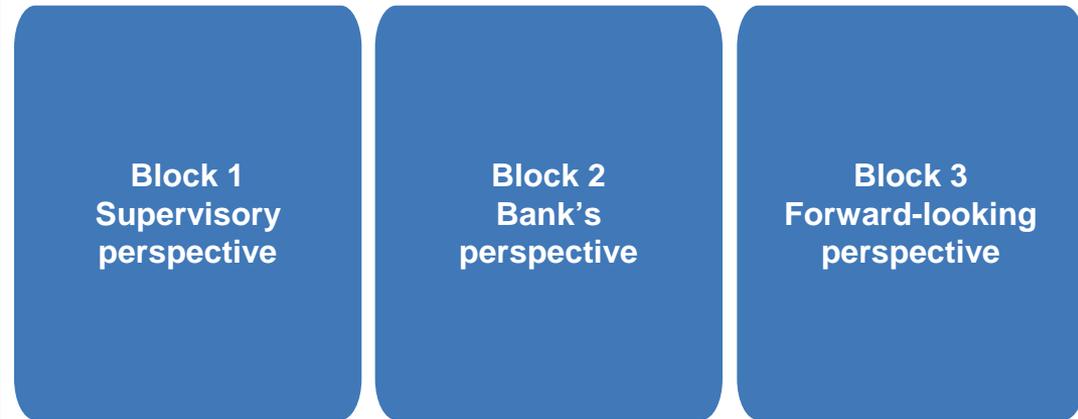
 **The results of both exercises will feed into the SREP**

Multiple perspectives on risk for capital adequacy



- After the JST has assessed the **three blocks**, it obtains a view on the institution’s capital needs from **three complementary angles**.
- It can compare these capital needs with the quantity and quality of capital that the institution holds and plans to raise in future.

3 Blocks - 3 Perspectives to assess capital adequacy



Risks to Liquidity

Three different perspectives (“3 Blocks”)

Block 1 Supervisory perspective

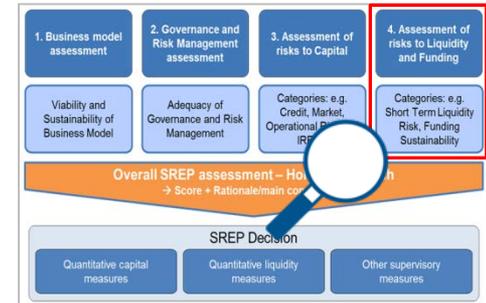
- Short term liquidity, funding sustainability
- ✓ Information gathering
- ✓ Anchoring scores on short-term liquidity and funding sustainability risks
- ✓ Comprehensive analysis

Block 2 Bank’s perspective

- ✓ Information gathering: e.g. ILAAP reports
- ✓ Anchoring assessment: challenge the institution’s internal estimates
- ✓ Comprehensive analysis: e.g. of ILAAP reliability

Block 3 Forward-looking perspective

- ✓ Information gathering: bank internal Stress Tests
- ✓ Anchoring assessment: supervisory Stress Tests
- ✓ Assessment of supervisory Stress Tests results and of bank’s internal Stress Tests



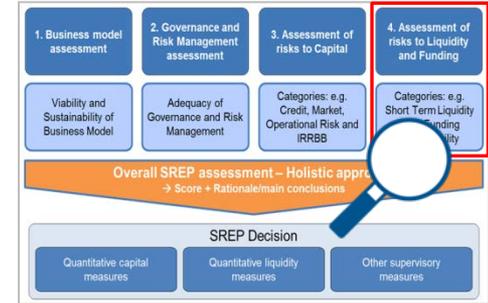
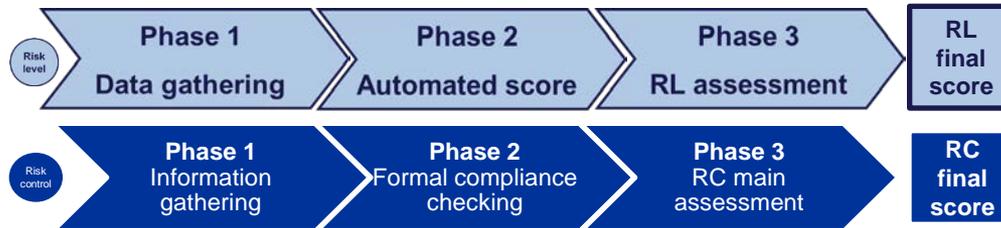
For SREP 2015

- ✓ Strongest weight on Block 1
- ✓ Block 2 not yet fully fledged
- ✓ Block 3 not yet fully fledged



In line with EBA SREP Guidelines, § 370-373

Risks to Liquidity - Block 1

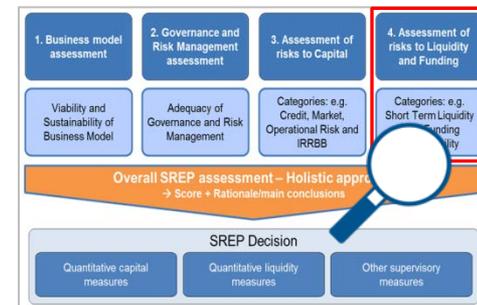


➔ Deep-dive into a given risk factor: **Short term liquidity** (example)

Phase 1	Phase 2	Phase 3
<p>➤ Risk Level:</p> <ul style="list-style-type: none"> • Sub-set of pre-defined indicators based on ITS and STE data <p>➤ Risk Control:</p> <ul style="list-style-type: none"> • Information gathering 	<p>➤ Risk Level:</p> <ul style="list-style-type: none"> • Automated score given through several indicators such as: <ul style="list-style-type: none"> • Liquidity Coverage Ratio • short-term funding / total funding <p>➤ Risk Control:</p> <ul style="list-style-type: none"> • Compliance checks relating to internal governance, risk appetite, risk management and internal audit 	<p>➤ Risk Level:</p> <ul style="list-style-type: none"> • Deeper analysis: <ul style="list-style-type: none"> • short term wholesale funding risk • intraday risk • quality of liquidity buffers • structural funding mismatch <p>➤ Risk Control:</p> <ul style="list-style-type: none"> • Deeper analysis, notably thanks to dedicated meetings with the bank

Risks to Liquidity - Block 2 and 3

- ILAAP reliability assessment
- Following ECB ILAAP expectations published on 08.01.2016, JSTs
 - assess reliability of the whole process - *qualitative assessment*
 - challenge ILAAP needs and stress test assumptions with SSM proxies - *quantitative assessment*
 - come up with block 2 and 3 assessment to feed the overall liquidity adequacy



ECB Banking Supervision: SSM priorities 2016 (extract)

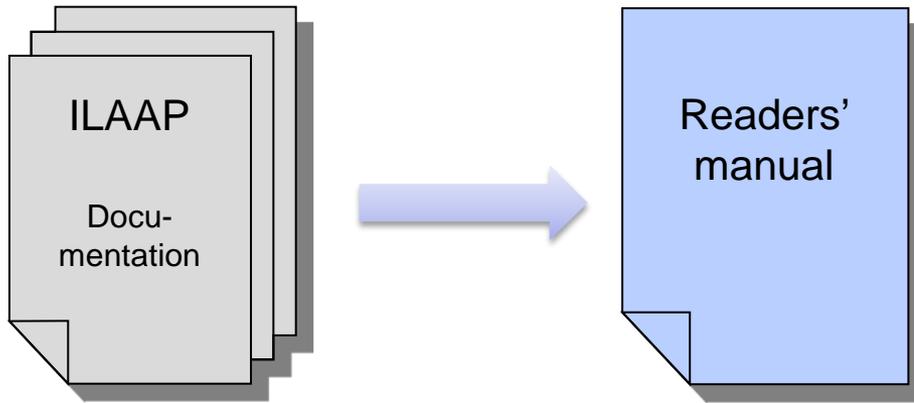
Liquidity

The 2015 Supervisory Review and Evaluation Process revealed that a number of banks do not yet fully meet supervisory expectations regarding the sound management of liquidity risks. The SSM will therefore focus on the reliability of banks' Internal Liquidity Adequacy Assessment Processes (ILAAP). Banks' progress in implementing and maintaining sound frameworks for managing liquidity and funding risk, both in a going concern situation and under stressed circumstances, will be scrutinised.

ECB ILAAP expectations

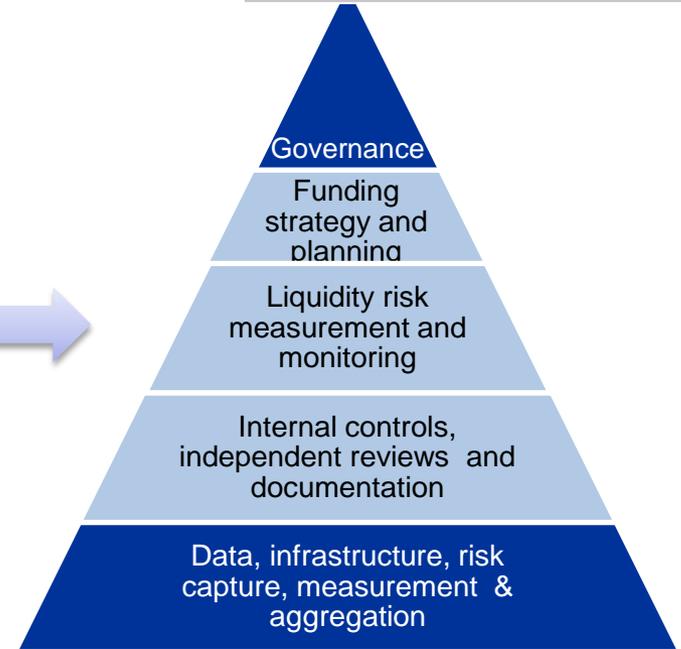
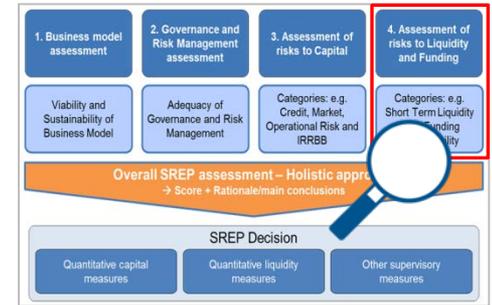
- Content as described in EBA draft Guidelines by end of April 2016 with reference date end of the previous year
- Internal documentation together with a "readers manual"
- Self-assessment
- Conclusions in form of liquidity adequacy statements supported by analysis of ILAAP outcomes and signed by management body

ILAAP - Qualitative assessment



Bank-internal documents as set out in EBA GL

Mapped to EBA GL structure to facilitate JST access to bank-internal information

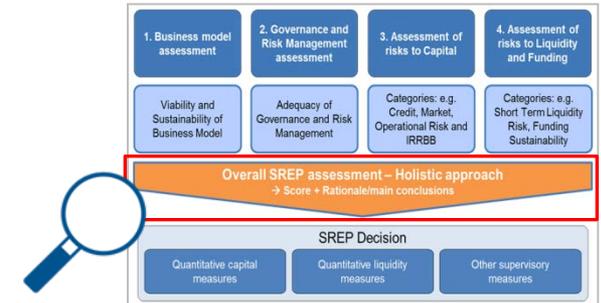


JST assessment

→ ILAAP reliable? (yes/no)

The overall SREP assessment (holistic view)

- Provides synthetic overview of an institution's risk profile:
 - Based on the assessment of all four elements (not the simple sum)
 - As a starting point the four SREP elements are considered equally important
- Takes into account:
 - the institution's capital/liquidity planning to ensure a sound trajectory towards the full implementation of CRD IV/CRR,
 - peer comparisons,
 - the macro environment under which the institution operates.

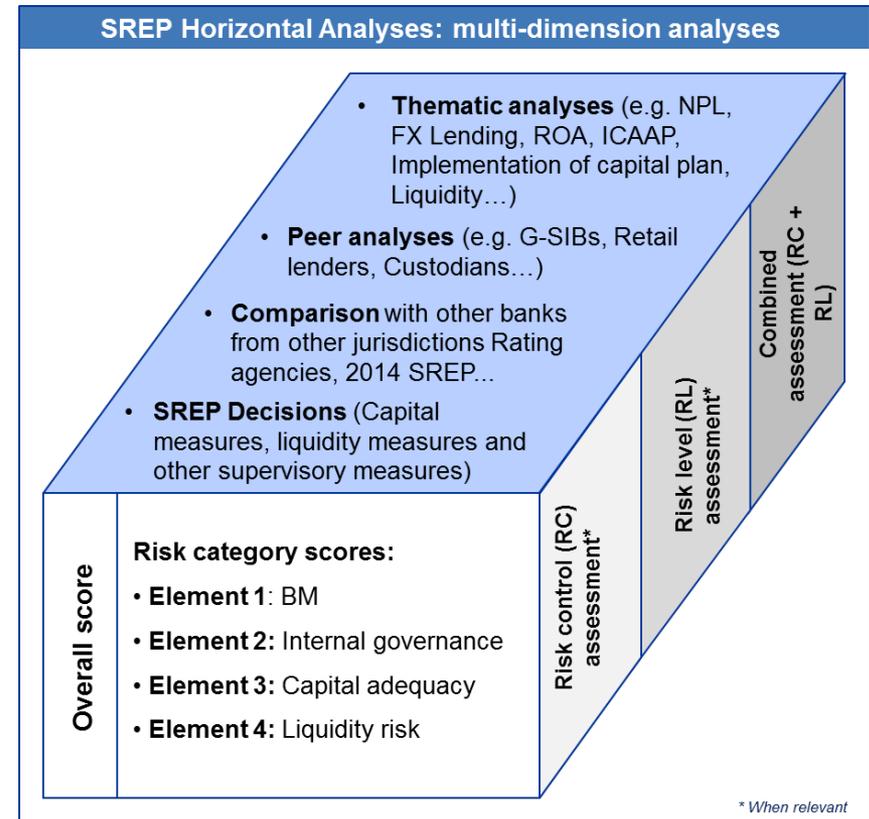


In line with the EBA SREP Guidelines (table 13, pp. 170 and 171), the overall SREP score reflects the supervisor's overall assessment of the viability of the institution: higher scores reflect an increased risk to the viability of the institution stemming from one or several features of its risk profile, including its business model, its internal governance framework, and individual risks to its solvency or liquidity position

An institution's risk profile is necessarily **multi-faceted**, and many risk factors are **inter-related**

Consistent and fair treatment

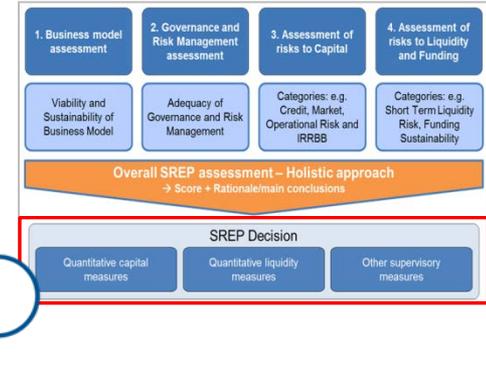
- **High Number of horizontal analyses** performed when preparing assessments and decisions in order to provide:
- Additional perspectives to JSTs
 - Support towards policy discussions and the decision making process



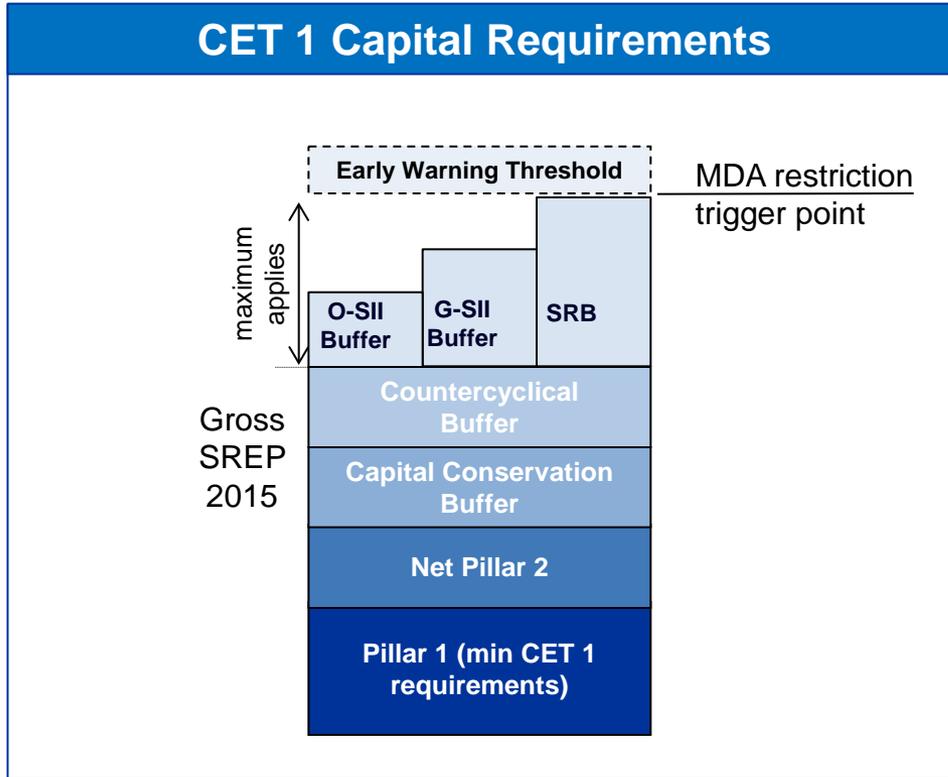
Extensive peer comparisons and transversal analyses were possible on a wide scale for the first time, allowing all institutions to be assessed in a **consistent manner** and thus promoting a **more integrated single banking market**.

The overall SREP is the basis for assessing capital and liquidity adequacy and for taking any necessary supervisory measures to address concerns

- SREP decisions by the Supervisory Board (followed by Governing Council non-objection procedure)
- SREP decisions may include:
 - **Additional own fund requirements**
 - In 2015 expressed as a CET1 ratio add-on (in excess of the minimum CET1 ratio)
 - Recommendation to follow a linear path towards “fully loaded” ratios
 - **Institution-specific quantitative liquidity requirements**
 - LCR higher than the regulatory minimum
 - Higher survival periods
 - National measures
 - **Other, qualitative supervisory measures**
 - Additional supervisory measures stemming from Article 16(2) of the SSM Regulation are e.g. the restriction or limitation of business, the requirement to reduce risks and the imposition of additional or more frequent reporting obligations.

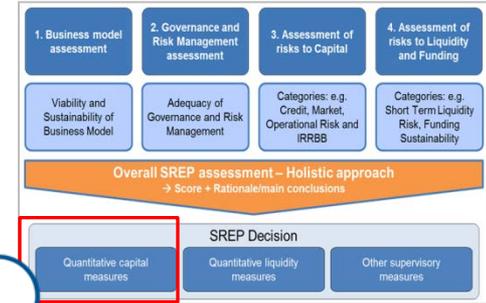


SREP decision - Capital measures



* *Maximum Distributable Amount:*

Breaches of the combined buffer requirement (CBR) - defined as the sum of the applicable buffers - lead to mandatory restrictions on distributions (e.g. dividends, coupon payments on AT1 capital instruments, discretionary bonuses). A bank which fails to meet its CBR will be automatically prohibited from distributing more than the so called Maximum Distributable Amount (MDA). The MDA is the bank's distributable profit multiplied by a factor ranging between 0.6 and 0 depending on how much CET1 capital is missing to meet the CBR.



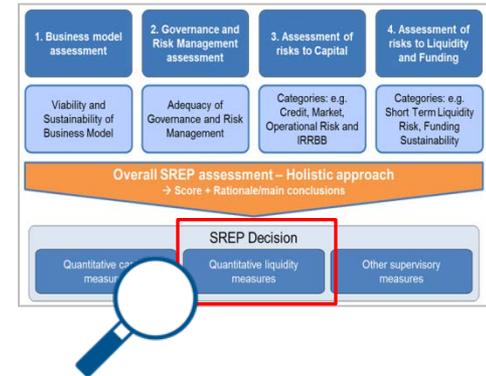
Focus on MDA* (in line with EBA Opinion of 18 December 2015)

- ✓ Stacking order: Pillar 1, Net Pillar 2, buffers
- ✓ In 2015 Pillar 2 requirements and (phase-in) buffers in CET 1
- ✓ CET1 capital to be taken into account for the MDA calculation is limited to the amount not used to meet the Pillar 1 and 2 CET 1 requirements

SREP decision - Liquidity measures

Concerning the institution-specific supervisory liquidity requirements for 2015:

- LCR requirements have come into force on 01.10.2015
- Liquidity assessment takes into account qualitative and quantitative assessment, including metrics such as:
 - funding profile
 - survival period
 - liquid assets
 - reliance on short-term wholesale funding applicable



Example of specific liquidity measures

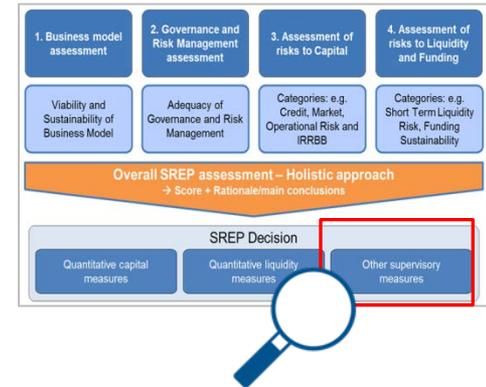
- ✓ require an LCR higher than the regulatory minimum
- ✓ require a specific minimum survival period
- ✓ require a minimum amount of liquid assets

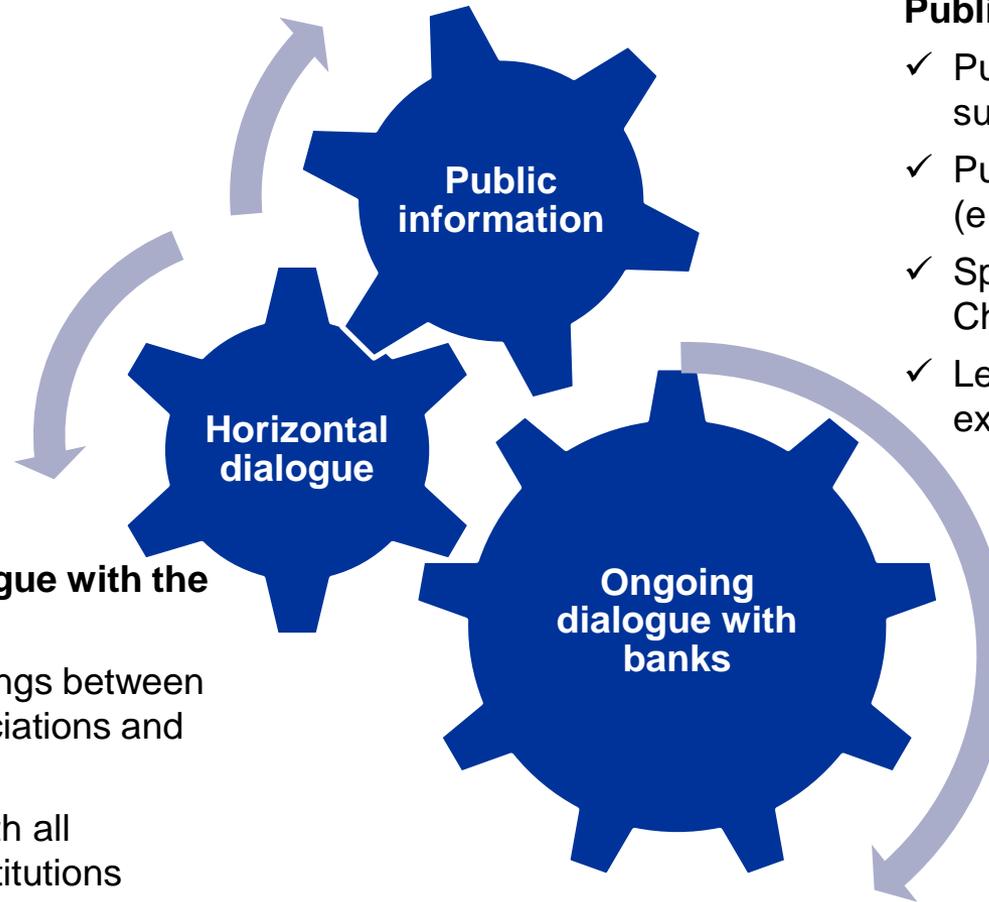
SREP decision - Other supervisory measures

Article 16(2) of the SSM Regulation

The ECB has the following powers:

- (a) to require institutions to hold own funds in excess of the capital requirements;
- (b) to require the reinforcement of the arrangements, processes, mechanisms and strategies;
- (c) to require institutions to present a plan to restore compliance with supervisory requirements and set a deadline for its implementation, (...);
- (d) to require institutions to apply a specific provisioning policy or treatment of assets in terms of own funds requirements;
- (e) to restrict or limit the business, operations or network of institutions or to request the divestment of activities that pose excessive risks to the soundness of an institution;
- (f) to require the reduction of the risk inherent in the activities, products and systems of institutions;
- (g) to require institutions to limit variable remuneration (...);
- (h) to require institutions to use net profits to strengthen own funds;
- (i) to restrict or prohibit distributions to shareholders, members or holders of Additional Tier 1 instruments where the prohibition does not constitute an event of default of the institution;
- (j) to impose additional or more frequent reporting requirements (...);
- (k) to impose specific liquidity requirements, including restrictions on maturity mismatches between assets and liabilities;
- (l) to require additional disclosures;
- (m) to remove at any time members from the management body of credit institutions





Horizontal dialogue with the industry:

- ✓ Regular meetings between Banking associations and DG MS IV
- ✓ Workshops with all Significant Institutions

Public information:

- ✓ Published “Guide to banking supervision”
- ✓ Publication of ECB stances (e.g. on MDA, remuneration, etc.)
- ✓ Speeches by Supervisory Board Chair and Vice-Chair
- ✓ Letters to MEPs, hearings and exchange of views with MEPs

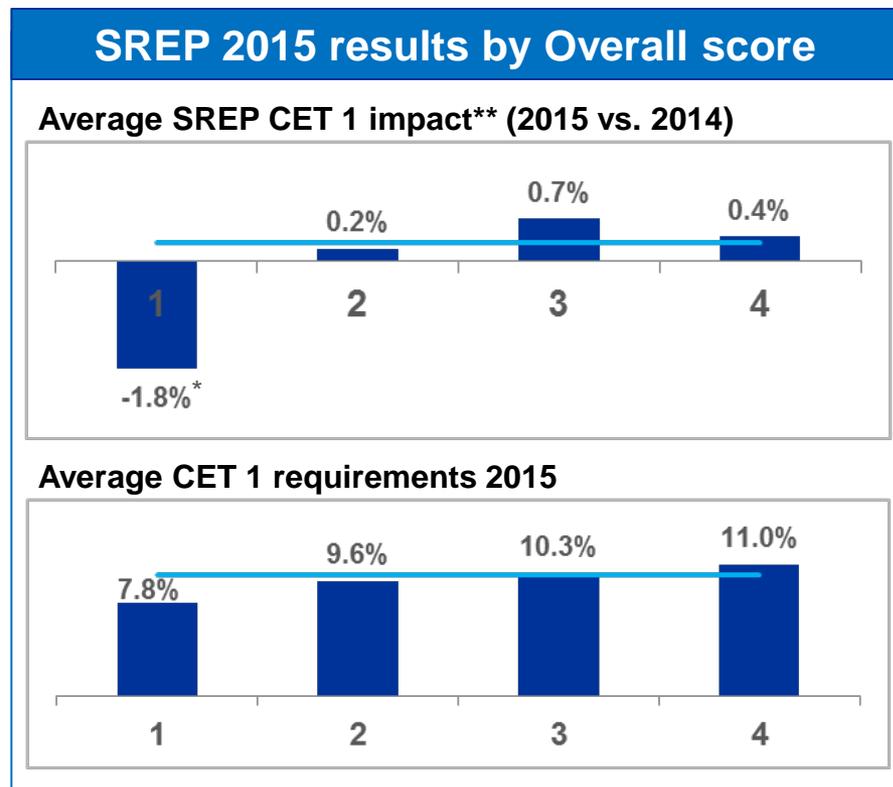
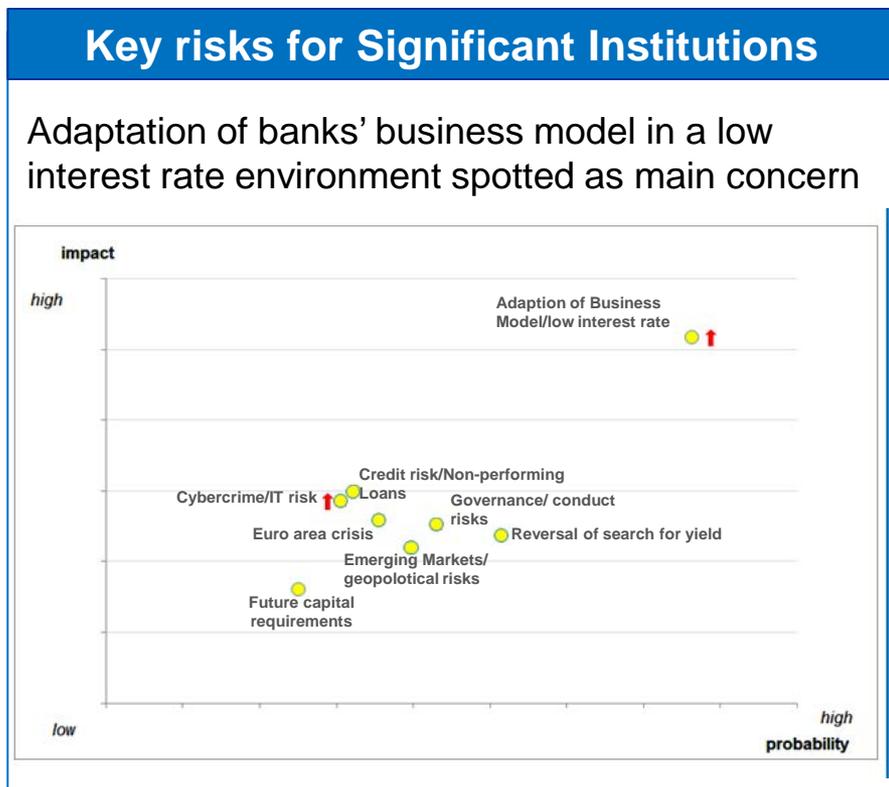
Ongoing dialogue with banks:

- ✓ Supervisory Examination Programme
- ✓ Meetings between banks and JSTs (especially ahead of SREP decision)
- ✓ SREP decisions (right to be heard)

Banks have

- ✓ the necessary clarity to understand the methodology, the risk assessment and to take the measures to improve,
- ✓ the necessary certainty to perform their capital planning.

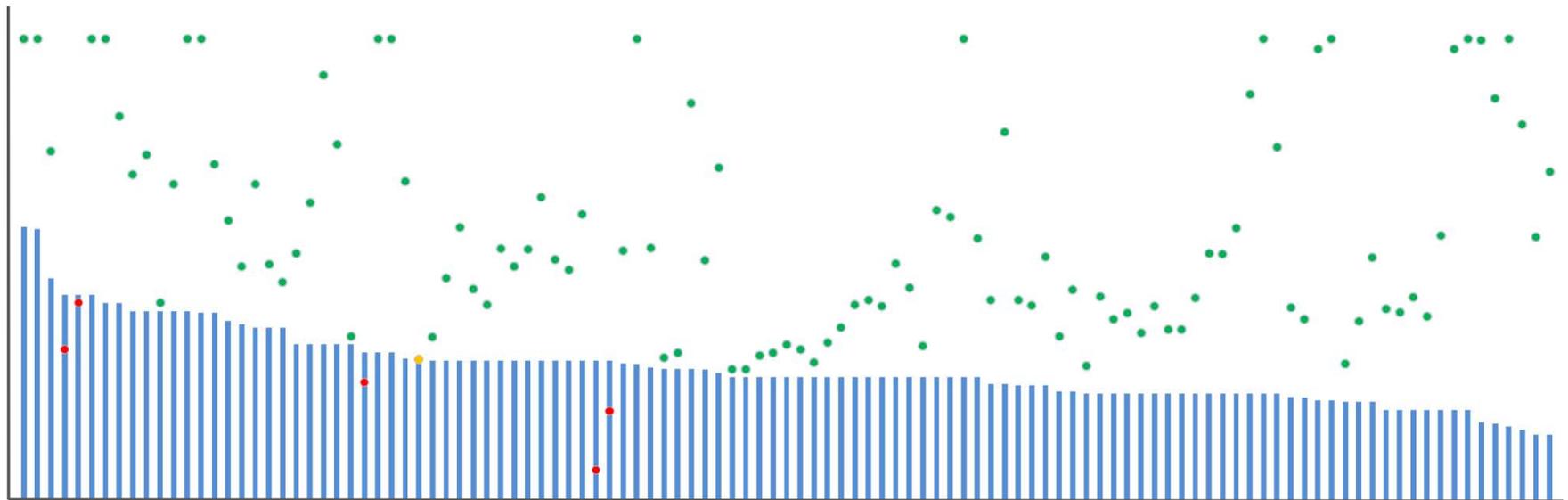
- Overall level of risks in 2015 for Significant Institutions has not decreased compared to 2014
→ The banking system’s capital needs to be maintained, and in some cases, strengthened
- **Overall capital requirements increased by 50 basis points (bps) from 2015 to 2016**
 - ✓ Many banks are still recovering from the 2012 financial crisis, and they continue to face risks and headwinds. In this context, compared to 2015, the **average Pillar 2 requirements increased by 30 bps.**
 - ✓ **Phasing-in systemic buffers** explain the second part of the capital requirements increase (20 bps).



* very few banks in this bucket lead to high volatility

** excluding Systemic Risk Buffers

Most Significant Institutions have currently capital levels above CET1 requirements and buffers

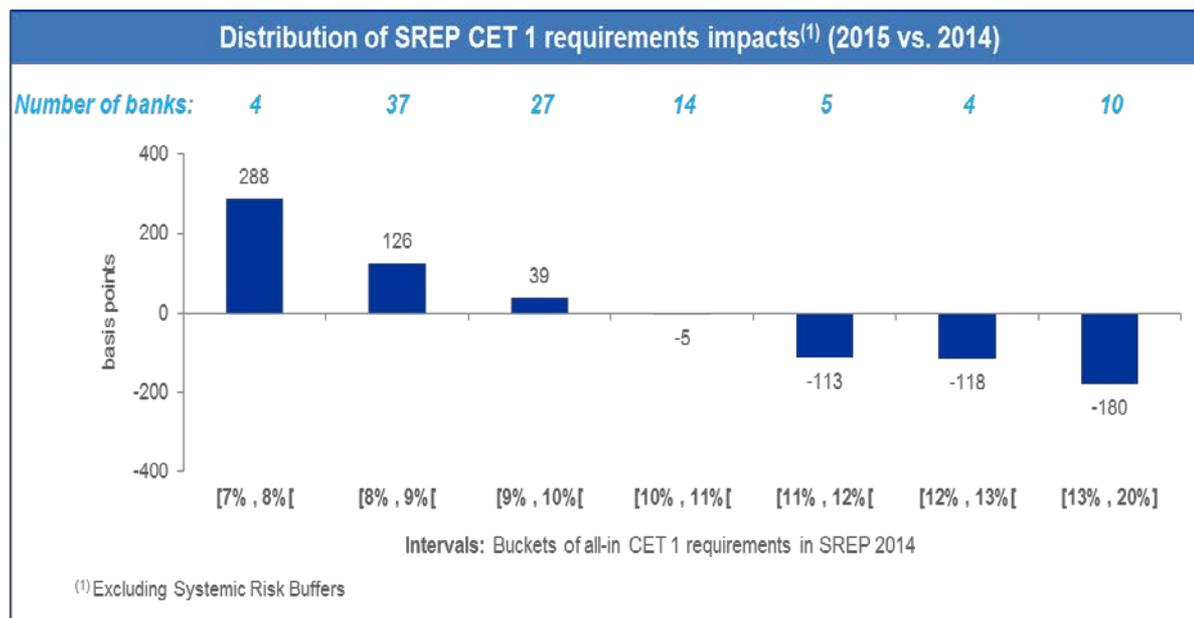


■ CET 1 ratio requirements (2016 phase-in)
 = Pillar 1 + Pillar 2 + Buffers (without early warning threshold of 25 bp)

- Banks with CET1 supply above CET 1 requirements and early warning threshold ratio
- Banks with CET1 supply above CET 1 requirements but below early warning threshold of 25bp
- Banks with CET 1 supply below CET 1 requirements

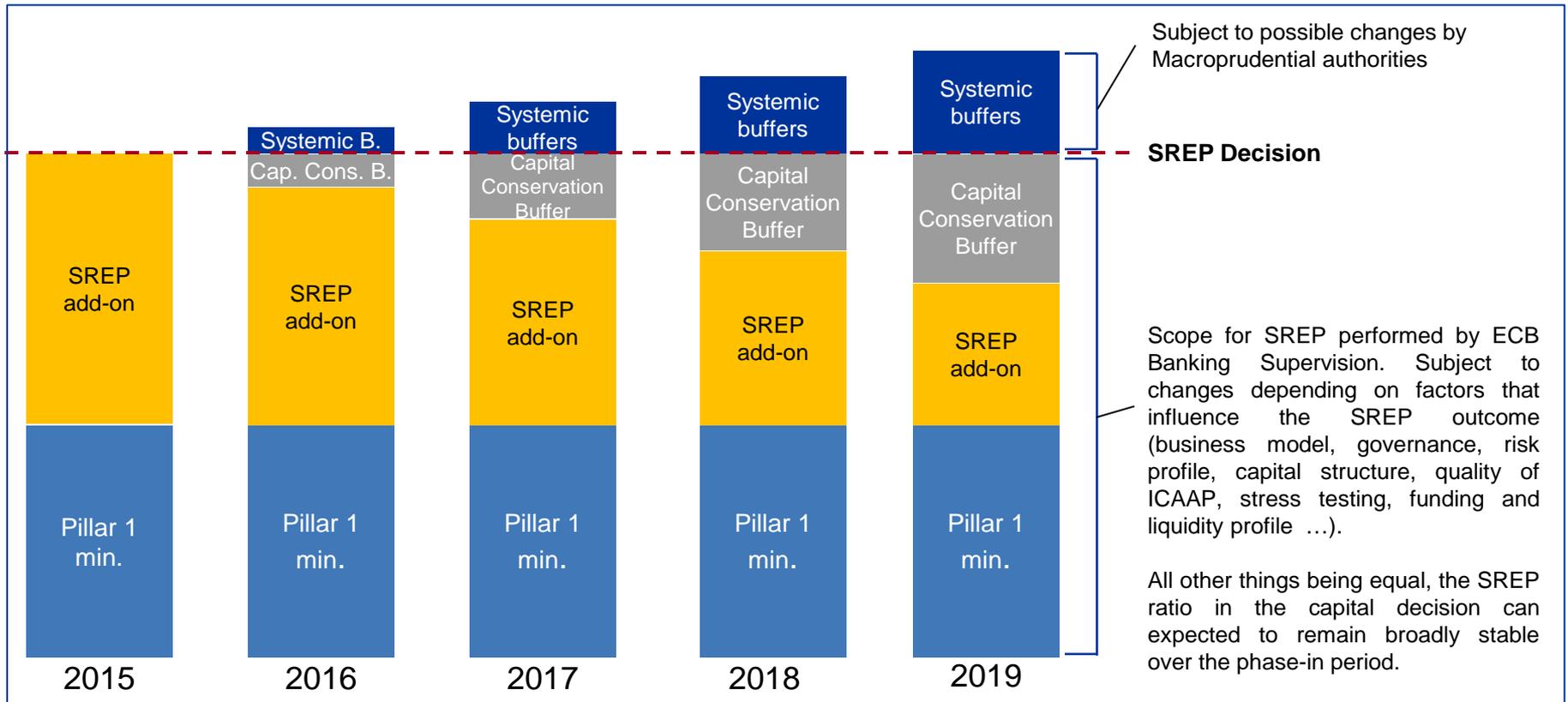
Note: CET1 supply level capped for readability purposes

- Average of SREP CET 1 requirements* of Significant Institutions is around 9.9%
- Median of SREP CET 1 requirements* of Significant Institutions is around 9.7%
- Harmonization of SREP CET 1 requirements achieved as part of the SREP 2015 with more consistent and risk-sensitive Pillar 2 CET 1 requirements



* excluding systemic risk buffers

All things being equal, the Pillar 2 requirements set out in the SREP 2015 decisions also provide an indication for the future; especially the capital conservation buffer will phase-in by 2019 with the Pillar 2 net requirement reducing in equal fashion.



Excludes Countercyclical Buffer and reduces the three different systemic buffers to one for simplicity

First SREP cycle could be performed efficiently and promoted a level-playing field

➤ Significant harmonization

- Constrained judgment effectively used
- Stronger correlation between risk profile of institutions and capital requirements

➤ In 2016, the SREP methodology will be refined on certain aspects, e.g.

- Liquidity and funding risk assessment
- More harmonized framework for the assessment of ICAAP
- 2016 stress tests under preparation

➤ Going forward, the SREP methodology will continue to evolve so as to adequately monitor banking activities and risks in a forward looking manner

