EBA'S REVISED SREP GUIDELINES: WHAT INSTITUTIONS SHOULD EXPECT IN THEIR 2019 SUPERVISORY ASSESSMENT

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2 ABSTRACT

On 19 July 2018, the European Banking Authority ('EBA') released several publications aligned to its Pillar 2 "Roadmap". These final revised Guidelines are aimed at enhancing institutions' risk management and increasing supervisory convergence in the supervisory review and evaluation process (SREP).

The comprehensive common EU SREP framework was established in 2014 and has been applied in practice since 2016. Following global regulatory developments, as well as the EBA's supervisory convergence assessments, specific changes were needed to reinforce the SREP framework.

The changes to the SREP Guidelines includes notably the following revisions: .

i) The introduction of Pillar 2 capital guidance;

ii) The integration of supervisory stress testing requirements and supervisory assessment of banks' stress testing;

iii) Further clarifications and details on the SREP scoring framework and on the articulation of total SREP capital requirements (TSCR) and overall capital requirements (OCR);

iv) Various consistency checks with relevant EBA standards and guidelines, in particular in the areas of internal governance and institution-wide controls assessment.

This Briefing Note focuses on the implications of these latest regulatory developments, highlighting areas that banks should carefully evaluate to address the requirements in a timely fashion, considering all compliance and associated operational issues.

3 OVERVIEW

While the SREP framework remains robust and serves the purpose of ensuring the convergence of supervisory practices, certain changes were considered necessary to reinforce the framework in the light of recent developments in the EU and international fora.

The revisions to the SREP Guidelines reflect the ongoing policy initiatives related to Pillar 2, which include, among other things:

- ✓ A clear definition of Pillar 2 requirements ('P2R') and Pillar 2 guidance ('P2G');
- ✓ Clarifications regarding the link between the supervisory assessment and P2R/P2G calibration;
- ✓ Clarifications regarding certain aspects of the SREP scoring framework;
- ✓ Further details on the articulation of total SREP capital requirements (TSCR) and overall capital requirements (OCR);
- ✓ An improved description regarding interactions between ICAAP, ILAAP and recovery plan;
- ✓ An improved description of the supervisory assessment within the SREP cycle and interactions between SREP elements; and
- ✓ The integration of supervisory stress testing requirements and supervisory assessment of banks' stress testing from the EBA Consultation Paper on Guidelines on stress testing and supervisory stress testing.

These final SREP guidelines aim to achieve the convergence of the practices followed by competent authorities across the EU. It **provides common organisation and governance requirements, methodologies and processes** for institutions' key strategic and internal processes.

4 KEY AREAS OF FOCUS

Our analysis focuses **on the key changes in EBA's revised SREP guidelines through:**

- A general overview introducing the different components introduced or amended in the guidelines; and
- A more detailed analysis on three key topics of interest.

GENERAL OVERVIEW

Since the publication and first application of the SREP Guidelines, there have been a significant number of developments affecting the SREP framework, which necessitated revisions to the guidelines.

In particular, these relate to the use of supervisory stress testing in SREP and the wider introduction of P2G in the 2016 EU-wide stress test, the revision by the BCBS of its IRRBB framework (which needs to be implemented in the EU legislation) and the clarification of the European framework for the application of the Maximum Distributable Amount (MDA).

Accordingly, the revisions to the SREP Guidelines **refine or introduce guidance on the following**:

1. P2G and supervisory stress testing;
2. The supervisory assessment of institutions' stress testing;
3. The alignment of the supervisory assessment of IRRBB with the revised EBA guidelines on IRRBB
4. The scoring framework
5. The interaction between SREP elements
6. The articulation of TSCR and OCR and the communication of supervisory capital expectations to institutions
7. The consistency with recently published legislation on internal governance

The new SREP framework aims to ensure consistency and coherence in institutions' assessments by setting operational and methodological requirements and framing the assignment of scores of the different key processes components. This will ultimately improve comparability between institutions.

Our analysis of the consultation paper focuses on three key topics:

- P2G and supervisory stress testing;
- The SREP scoring framework; and
- The interaction between SREP elements.

FOCUS ON P2G AND SUPERVISORY STRESS TESTING

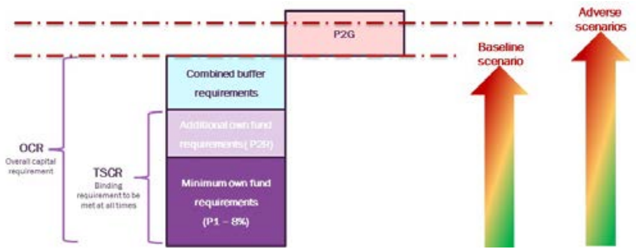
Having recently been introduced by the ECB as a key outcome of SREP 2017, the concept of P2G is clarified in the revised guidelines, notably regarding its calibration and how it is linked to supervisory stress testing.

1. Meeting requirements in stressed conditions

As part of the assessment of capital adequacy, competent authorities should also determine **whether applicable own funds requirements (quantity and composition) can be met in stressed conditions.**

To assess capital adequacy in stressed conditions, competent authorities should consider:

1. The use of the **qualitative outcomes** (e.g. deficiencies identified in risk management and control) of institutions' stress tests and supervisory stress testing; and
2. The use of the **quantitative outcomes of ICAAP stress tests**, if the ICAAP is deemed reliable and of supervisory stress tests (i.e. outcomes in terms of changes in own funds ratios).



Competent authorities should assess as appropriate the quantitative outcomes of stress tests with regard to the adequacy and quality of the institution's own funds and determine whether the quantity and quality of own funds are sufficient to cover applicable capital requirements, and in particular:

1. **OCR including its combined buffer requirements <u>under</u> the baseline scenario** over a forward-looking time horizon of at least two years;
2. **TSCR <u>under</u> the adverse scenarios** over a forward-looking time horizon of at least two years; or
3. where relevant, predefined target ratios (fixed threshold) set in the context of a system-wide stress test, for the applicable stress test scenarios.

2. P2G calibration: the assessment of supervisory stress testing

As part of the assessment of capital adequacy, competent authorities should also determine whether **applicable own funds requirements <u>can be met in stressed conditions.</u>** For this purpose, competent authorities set P2G. A positive value of the P2G aims to address supervisory concerns **about the sensitivity of the institution to the adverse scenarios used in the supervisory stress tests.** Where the quantitative outcomes of the supervisory stress tests suggest that the institution is not expected **<u>to breach its TSCR under the adverse stress test scenario</u>, <u>competent authorities may decide not to set P2G.</u>**

i) P2G calculation and the key role of supervisory stress tests

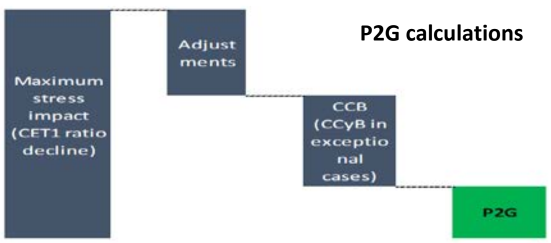
The determination and calibration of the P2G by competent authorities **is based on the outcomes of the <u>adverse scenario</u> of the relevant supervisory stress tests**, including the EU-wide stress tests performed by the EBA or any other relevant supervisory stress tests performed on a system-wide basis using a multi-factor scenario analysis **over the forward-looking horizon of at least two years** (either top-down or bottom-up). The P2G level should at least **cover the anticipated maximum stress impact**, which should be calculated based on the changes in the CET1 ratio.

When determined, the P2G is expected to be:

- ✓ Met with CET1 eligible own funds;
- ✓ Incorporated into institution's capital planning; and
- ✓ Embedded in the institution's risk management framework, including the RAF and the recovery plan.

The SREP guidelines[1] provide two different approaches for the **maximum stress impact** calculations under the adverse scenario:

1. Calculation of **the CET1 ratio in the worst year** looking only at the impacts of the scenario on the CET1 capital **while keeping TREA unchanged from the reference date** (CET1 in the worst year/TREA in T_0); and
2. Calculation of the **CET1 ratio in the worst year taking into account** the impact of the scenario on **both CET1 capital and TREA in the worst year.**



3. Comparative analysis between P2R and P2G

A comparative analysis[2] between the P2R and the P2G is presented in this section. It allows to better understand the aim and complementarity of both ratios.

P2R	P2G
Nature	
Requirement on top of Pillar 1 and below the combined buffer requirement set in accordance with Article 104 of the CRD	Expectation on top of the combined buffer requirement
Scope	
(1) Risk of unexpected losses over 12 months not covered by minimum requirements; (2) Risk of expected losses over 12 months insufficiently covered by provisions; (3) Risk of underestimation of risk due to model deficiencies; (4) Risks arising from governance deficiencies	Quantitative outcomes of relevant stress tests (other potential areas to be explored further)
Determination	
Calculation based on ICAAP as a starting point, where assessed as reliable, supported by, for example, supervisory benchmarks applied in relation to ICAAP calculations, supervisory judgement, etc	Calculation **based on the maximum impact of the adverse scenario on the CET1 ratio**, adjusted, for example, for credible mitigating actions and other factors, and offset against the own funds held to meet the CCB and in exceptional cases the CCyB if it covers the same risks assumed in the stress test
Quality of capacity	
Regulatory eligible own funds, at least in the same composition as Pillar 1	CET1 only
Relevance for the restrictions on distributions under Article 141 of Directive	
Yes	No
Communication to institution	
Part of the TSCR ratio articulated in relation to all Pillar 1 ratios (total own funds, T1, CET1)	**As a separate ratio**, not part of TSCR or OCR, explaining how it affects all capital ratios (T1 and total own funds)
Compliance	
Requirements to be met at all times, including in stressed conditions	Institutions are expected to incorporate P2G into their capital planning, risk management and recovery planning, and operate above P2G
Supervisory response to breaches	
All supervisory measures can be applied; a breach is a potential condition for the withdrawal of authorisation; an institution in breach is considered failing or likely to fail for resolution purposes	No automatic link between the level of own funds falling below P2G and specific supervisory measures, but would trigger enhanced supervisory dialogue and engagement with an institution, as there is a need to provide a credible capital plan

[1] Final Guidelines on the revised procedures and methodologies for the SREP

[2] Final Guidelines on the revised procedures and methodologies for the SREP

FOCUS ON THE SREP SCORING FRAMEWORK

Through these guidelines, the EBA has refined and strengthened the SREP scoring framework as further clarifications have been included with regard to the assessment of SREP elements.

These revisions further clarify **the two types of scores introduced** in the initial version of the SREP Guidelines:

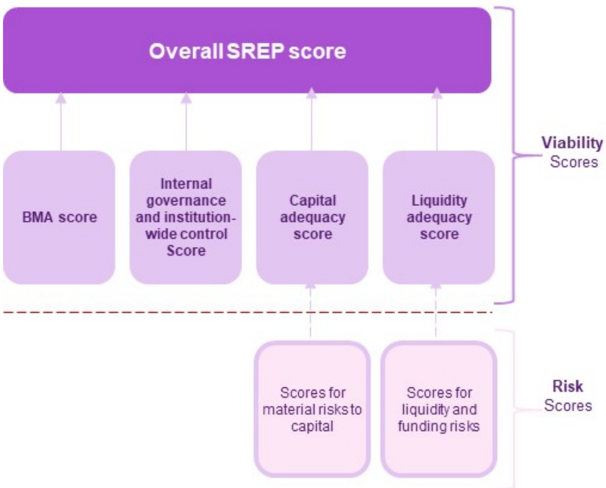
1. **Risk scores**: applied to **individual risks to capital, liquidity and funding** that indicate **the likelihood that a risk will have a significant prudential impact on the institution (e.g. a potential loss); and**
2. **Viability scores** are assigned to each of the SREP components and to the overall SREP score indicating **the magnitude of the risk to the institution's viability stemming from the SREP element assessed.**

Importantly, risk scores feed into two viability scores:

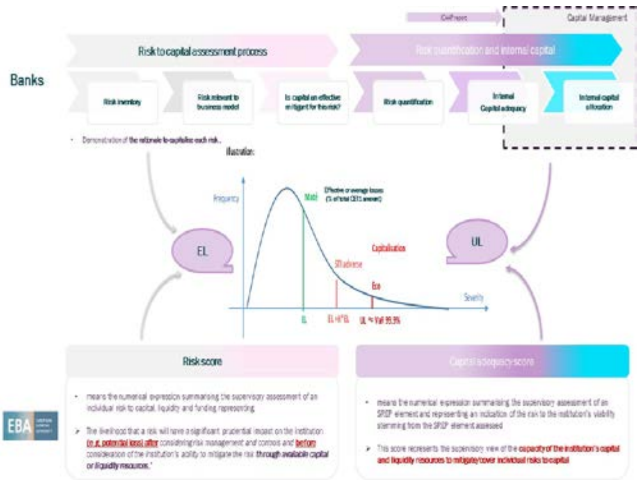
- **Capital adequacy score** - as a result of the assessment of all material risks to capital (e.g. credit, market, operational, etc); and
- **Liquidity adequacy score** - as a result of the assessment of liquidity and funding risks.

Competent authorities should assign a score between 1 (low risk) and 4 (high risk) to reflect the 'supervisory view' for each element.

Overview of the scoring framework

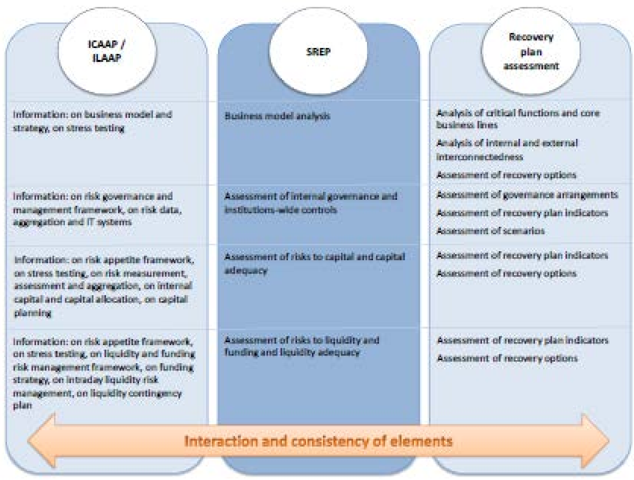


Our analysis between the scoring framework and strategic processes is illustrated below.



While the SREP process is a key supervisory tool, it must also interact with other supervisor processes. In particular, competent authorities should reflect in SREP assessments available information and outcomes from all other supervisory activities. An important example of such complementary analyses is the interaction between SREP and the assessment of recovery plan. The outcomes of the assessment of recovery plan feed into the SREP assessment and vice versa.

Below is a reproduction of the illustration by the EBA [3] describing the interaction and the consistency between the SREP, the ICAAP, the ILAAP and the Recovery plan assessment.



3 Final Guidelines on the revised procedures and methodologies for the SREP

5 CONCLUSION

The topics discussed above provide a clear outline of the planned evolution of the SREP process in the coming years, which will present banks with multiple challenges.

The main changes to the SREP guidelines will push banks to better understand and plan for this assessment as well as the calibration of the outcomes. The SREP process should be seen as an opportunity for banks to strengthen and better integrate key processes into their decision-making processes.

It is essential that banks adjust and strengthen their internal processes to better withstand the challenge posed by the key elements of the SREP. In particular, the link between and risks and viability scores should be put into the perspective of the maturity of their business model assessment, and their ICAAP and the ILAAP processes.

6 ABOUT AVANTAGE REPLY

Avantage Reply (a member of the Reply Group) is a pan-European specialised management consultancy delivering change initiatives in Risk, Compliance, Finance (Capital Management and Regulatory Reporting), Treasury and Operations within the Financial Services industry.

Within our core competencies, we have extensive experience in implementing changes driven by:

- Industry-wide legislative and regulatory initiatives (e.g. CRD, BRRD);
- Mergers, Acquisitions & Divestments (e.g. business combination, separation and flotation); and
- Business improvement and optimisation agendas (e.g. risk appetite and capital allocation).

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