The Revised Guidelines on Common Procedures and Methodologies for SREP and Supervisory Stress Testing EBA/GL/2022/03

On the 18 March 2022 the European Banking Authority ('EBA') published the final report on the Guidelines on common procedures and methodologies for the Supervisory Review and Evaluation Process (SREP) and supervisory stress testing under Directive 2013/36/EU ('CRD IV').

The guidelines will apply from 1 January 2023 and apply to competent authorities when assessing institutions subject to CRD. This report marks the second revision of these guidelines which were first published in 2014 after the application of the CRD IV and aims to account for the amendments stemming from 2019/878/EU ('CRD V'), i.e. the Banking Package.

While the Guidelines are addressed to competent authorities and are intended to promote common procedures and methodologies for the Supervisory Review and Evaluation Process ('SREP'), institutions should take note and prepare accordingly for the changes to the supervisory review process they will be subject to from 1 January 2023.

Key Updates

AML/CFT now part of SREP
The updated guidelines reflect the need for greater cross functional supervisory cooperation across Prudential Supervision, Resolution Planning and AML/CFT Supervisors. Indeed, the formal recognition of AML/CFT risks in the prudential assessment of business model, internal governance and overall risk management will be a step change.

New optionality for P2G
Revised optional methodology for calculating P2G has also been introduced. The introduction of the bucketing approach (bucket and P2G range informed by capital ratio depletion in stress) and the possibility to use simplified forms of stress tests for proportionality purposes, have provided additional optionality to competent authorities to set P2G levels. P2G is also required to be met with CET 1.

Additional clarity and proportionality
The Guidelines also implore that competent authorities use an institution specific risk by risk approach and use the ICAAP in determining an institution's capital adequacy and P2R level, as well asconsideration of additional capital specifically required in respect of excessive leverage (P2R-LR). In addition, the refinement of the application of the principle of proportionality, and in particular the updated categorisation of institutions should be welcome clarity for industry.

Details
The Guidelines contain twelve separate titles:
- Title 1. Subject matter, definitions, level of application and implementation
- Title 2. The common SREP
- Title 3. Monitoring of key indicators
- Title 4. Business model analysis• Title 5. Assessing internal governance and institution-wide controls
- Title 6. Assessing risks to capital
- Title 7. SREP capital assessment
- Title 8. Assessing risks to liquidity and funding
- Title 9. SREP liquidity assessment
- Title 10. Overall SREP assessment and application of supervisory measures
- Title 11. Application of the SREP to cross-border groups
- Title 12. Supervisory stress testing

A scoring framework is included within the guidelines to foster comparability and a level playing field across institutions as well as to adequately prioritise supervisory resources and measures in the assessment of SREP elements, competent authorities should score from a range of '1' (low risk) to '4' (high risk), to reflect the supervisory view for reach element-specific title of the guidelines. The scoring system is calculated using the below methodology.

The overall own funds requirements stacks are included within the guidelines. The diagram below outlines the capital, or own funds, requirements for institutions with regard to the Total Risk Exposure Amount ('TREA') and also specifically for Leverage Risk ('LR').

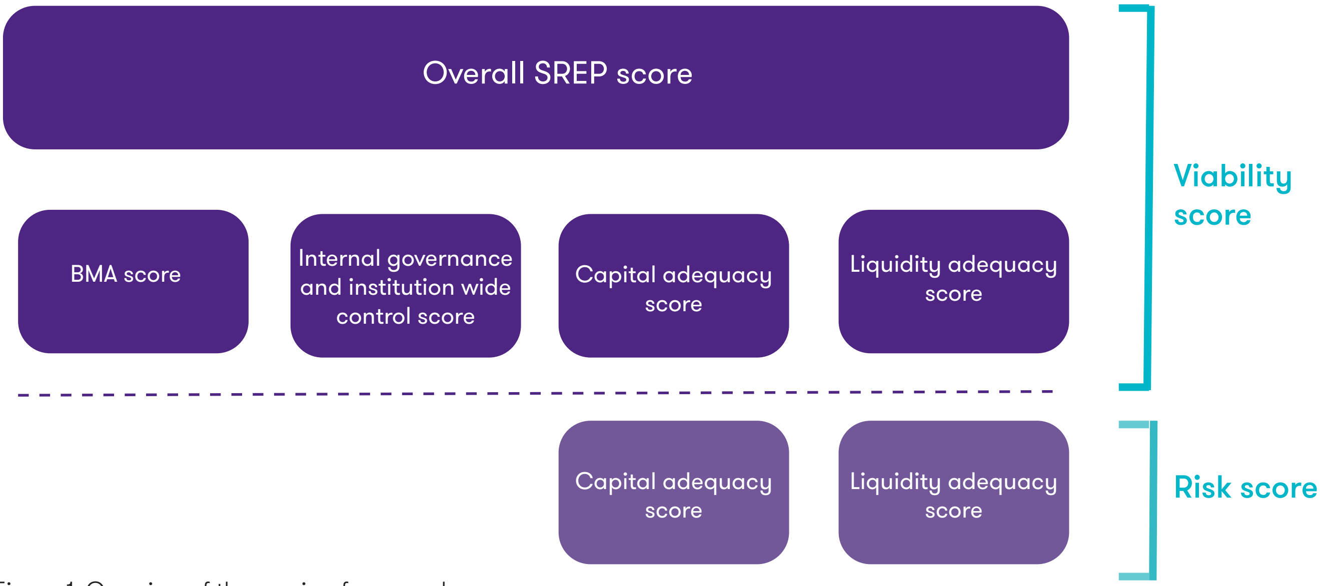

Figure 1. Overview of the scoring framework

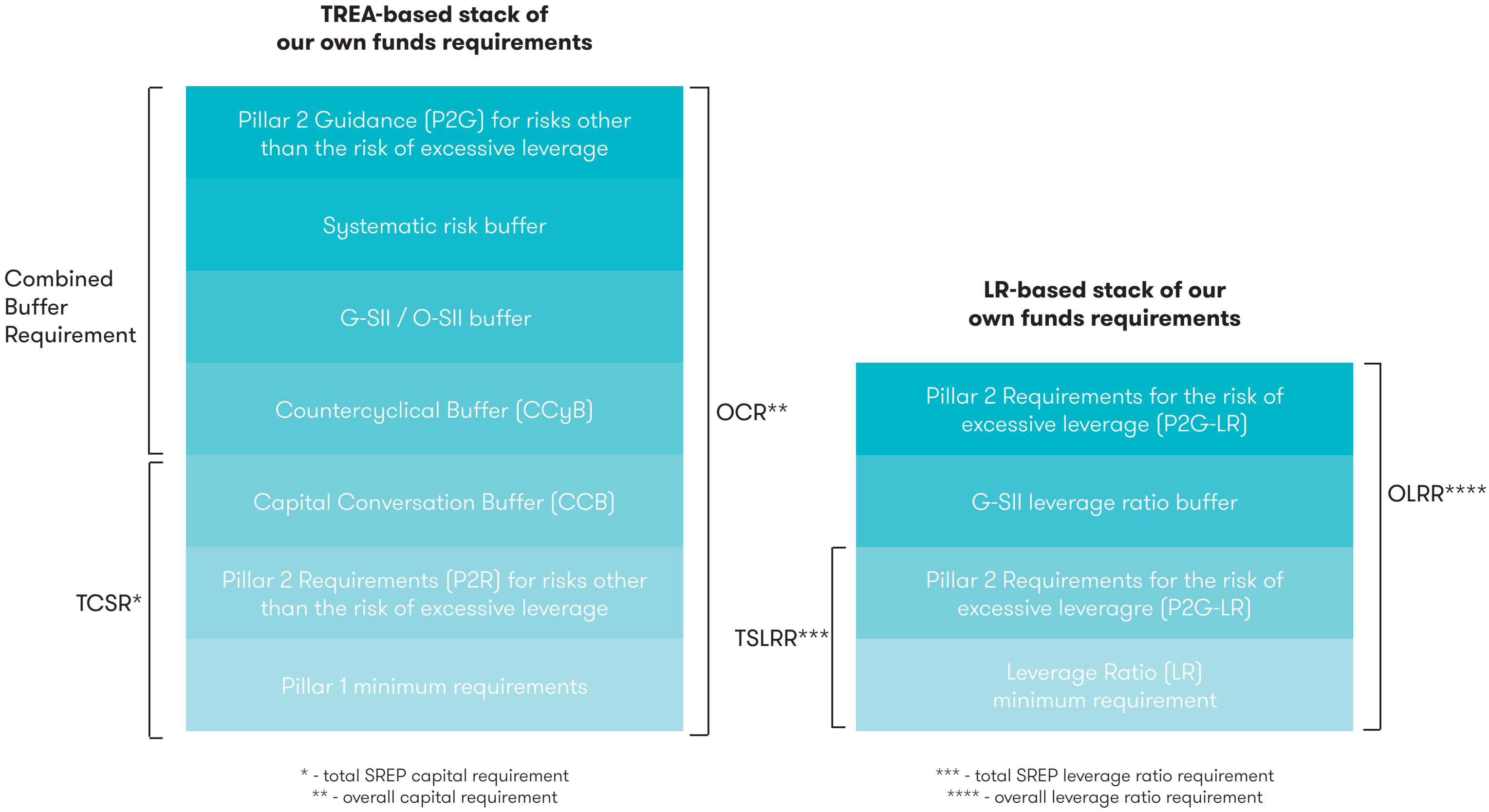

Figure 2. Stacks of Own Funds Requirements

The guidelines also provide the framework for assessing liquidity and funding risk within an institution. The below diagram outlines the framework an assessment of liquidity and funding risk should follow.

The changes to these Guidelines do not alter the overall SREP framework but affect its main elements, including (i) business model analysis, (ii) assessment of internal governance and institution-wide control arrangements, (iii) assessment of risks to capital and adequacy of capital to cover these risks, and (iv) assessment of risks to liquidity and funding and adequacy of liquidity resources to cover these risks. A number of amendments were introduced throughout the document as outlined below.

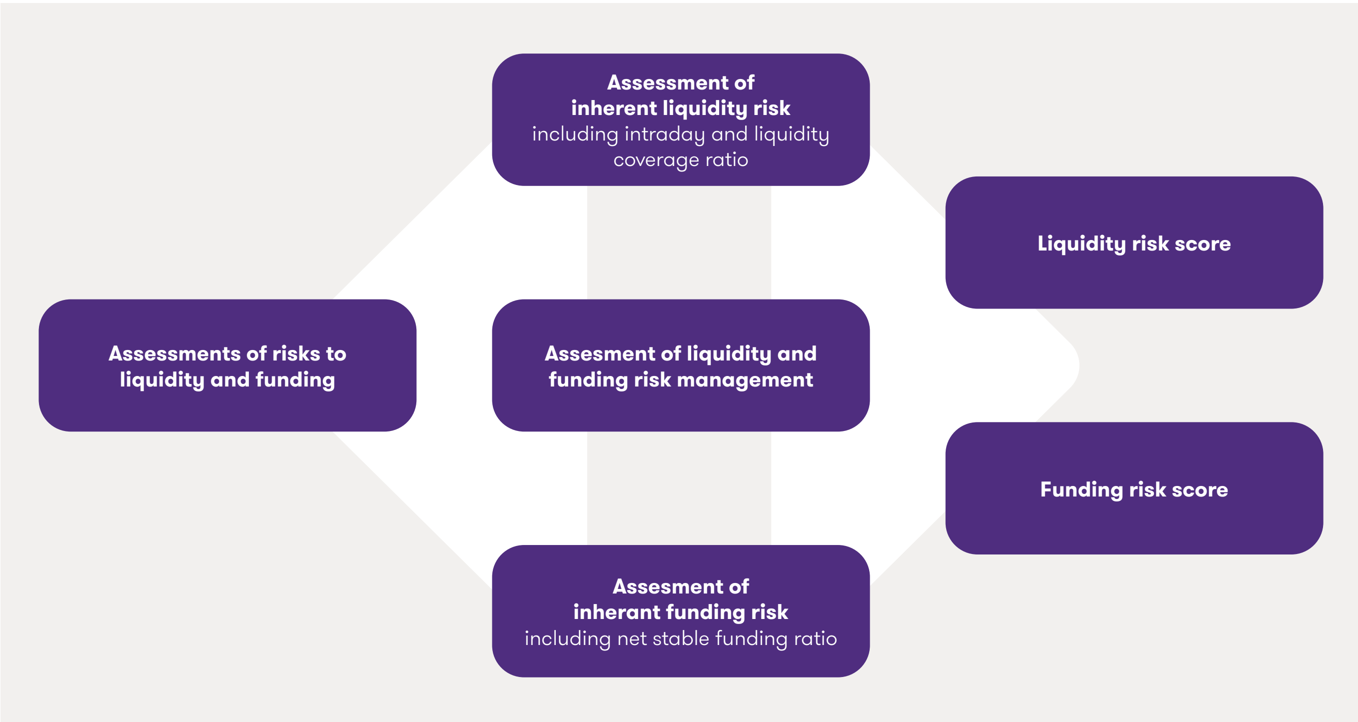

Figure 3. Elements of the Assessment of Risks to Liquidity and Funding

Money Laundering and Terrorist Financing (ML/TF) risks

Money Laundering and terrorist financing risks have been defined and included within the scope for institutions to monitor and analyse as part of their consideration of business model analysis, risk assessments and governance arrangements. This means AML/CFT risk assessment is now formally in scope for Prudential Supervision.

Principle of Proportionality

Definitions for categories of institutions have been aligned to reflect the Capital Requirement Regulation definitions. This amendment aims to better articulate the principle of proportionality, through the categorisation of institutions and the application of the minimum engagement model. The minimum engagement model outlines the minimum engagement levels expected between institutions and competent authorities per institution category. Institutions need to ensure they know which category they fall into and plan accordingly.

Category (as defined in CRD and EBA GLs)	Monitoring of key indicators	Assessment of all SREP elements (at least)	Summary of the overall SREP assessment	Minimum level of engagement/ dialogue
1 Large	Quarterly	Annual	Annual	Ongoing engagement with institution's management body and senior management; engagement with institution for assessment of each element
2 Medium to Large	Quarterly	Every 2 years	Annual	Ongoing engagement with institution's management body and senior management; engagement with institution for assessment of each element.
3 Small to Medium	Quarterly	Every 3 years	Annual	Risk-based engagement with institution's management body and senior management; engagement with institution for assessment of material risk element(s) .
4 Small and Non Complex	Quarterly	Every 3 years with the scope and depth of the review tailored to the specific risk profile of the institution	Annual	Risk-based engagement with institution's management body and senior management; engagement with institution for assessment of material risk element(s) .

Alignment of Governance Obligations

Institutions assessments of governance obligations have been aligned to updated EBA Guidelines on internal governance, sound remuneration, fitness and probity, outsourcing arrangements and stress testing.

Pillar 2 Requirements

Updates have been introduced to the provisions on Pillar 2 capital add-ons ('P2R') and the Pillar 2 Guidance ('P2G'), to ensure they reflect a purely micro-prudential perspective and appropriately implement the separate stack of own funds requirements based on the leverage ratio.

The Guidelines outline Institution-specific characteristics of P2R and provide clarity on the risk-by-risk approach, the use of ICAAP for calculating P2R, setting P2R for deficiencies in internal governance, business model and internal models and information on the Minimum Capital composition.

With regard to Pillar 2 capital add-ons for excessive leverage (P2R-LR) the Guidelines outline that leverage should be assessed similarly as for other risks, including reference to the same sources of information and the use of ICAAP. Additionally, P2R-LR is to be covered by Tier 1 capital, with a possibility to require higher quality of capital if justified.

Revised optional methodology for calculating P2G has been introduced. The introduction of the bucketing approach and the possibility to use simplified forms of stress tests for proportionality purposes have provided additional optionality to competent authorities to appropriately set P2G levels. P2G is also required to be met with CET 1.

Assessments of liquidity risk and Interest rate risk in the non-trading book

The assessment of liquidity and funding risks have been updated to include the Liquidity Coverage Ratio and Net Stable Funding Ratio. Further specification of indicators to be used to assess liquidity and funding risk have been outlined. Interest Rate Risk in the Banking Book ('IRRBB') / Credit Spread Risk in the Banking Book assessment have been updated to align with CRD requirements and references to future RTS and GL.

Next Steps

Institutions should ensure they are fully prepared. Full incorporation of an assessment of money laundering and terrorist financing within risk management processes is required by January 2023. Institutions should ensure they understand and pre-empt the amendments to Pillar 2 capital add-ons and the Pillar 2 guidance and the capital quality required to meet these requirements. The updated guidelines on governance arrangements should be accounted for within an organisations governance framework.
Depending on the size and scale of the institution (set by category per the Guidelines) the level of interactions institutions has with the regulator may change due to the implementation of the proportionality amendments and the minimum engagement model. Institutions should endeavour to understand the changes brought about by this amendment and ensure they have the appropriate resources to meet regulatory expectations.

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