

## MEMORANDUM



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### **Method for Supervisory Review and Evaluation Process (SREP)**

#### **Summary**

This memorandum discusses how Finansinspektionen (FI) intends to apply the regulations regarding the so-called Pillar 2 of the capital adequacy legislation in light of the overall requirements contained in the business legislation for credit institutions and investment firms. This memorandum is a living document and can thereby be changed later if the conditions change in any respect.

The business legislation's requirements that undertakings maintain capital to cover all risks that they are exposed to go farther than the specified own funds requirement contained in the Capital Adequacy Act, the so-called Pillar 1. The connection between the two is achieved by Pillar 2. The undertakings within the framework of an ICAAP should arrive at a total assessed capital need for all current risks in the operation, including those which were dealt with in Pillar 1. They should also report the target level of capital that the board of directors has decided on. FI will assess whether the institution's methods for the evaluation are reasonable and whether the intended target level of capital can be considered satisfactory. In other words, FI needs to assess what is a reasonable target level of capital for the respective undertaking, given the risks that it is exposed to, and whether it has a sound management of its risks.

The capital assessment in Pillar 2 need not lead to an exactly specified amount for the capital need. The intention is rather to conduct a dialogue between the institution and FI on the amount of the institution's own funds that seems reasonable while taking into account the risks that the institution is exposed to and what level the institution should have as a target in its capital planning. If a mutual view cannot be attained in this way, the extreme possibility exists for FI to decide on an extended own funds requirement which would then become binding.

The institution concerned shall be informed regarding FI's conclusions of the SREP. A number of examples of how such conclusions can be worded in different situations can be found in Appendix 1.

A number of different terms associated with capital and capital planning are used in this memorandum. A glossary specifying the intended meaning of these terms can be found in Appendix 2.

## Background

Article 123 in Directive 2006/48/EC states that a credit institution<sup>1</sup> shall have in place sound, effective and complete strategies and processes to assess and maintain on an ongoing basis the amounts, types and distribution of internal capital that they consider adequate to cover the nature and level of the risks to which they are or might be exposed. These strategies and processes shall be subject to regular internal review to ensure that they remain comprehensive and proportionate to the nature, scale and complexity of the activities of the credit institution concerned.

The provisions of the Article have been implemented in Chapter 6, sections 1, 2 and 5 of the Banking and Financing Business Act (LBF). Even if the wording in the Act is not the same as in the Directive, the provisions, according to the Ministry of Finance, are sufficient to incorporate the Directive's Article 123. In a similar way, the implementation in the issue regarding investment firms has been resolved by Chapter 8, sections 3, 4 and 8 of the Securities Market Act (LVPM)<sup>2</sup>.

In its supervision, FI will especially review and evaluate whether the institution fulfils the requirements in Chapter 6 of LBF and the regulations issued with the support of this Act. FI shall establish how and how often this review should take place. What the review should include at a minimum is covered by section 30 of the ordinance on capital adequacy and large exposures.

The review shall result in a standpoint on whether the measures that an institution has taken in order to comply with the Directive are sufficient in order to ensure a sound management of the institution's risks and whether the own funds are adequate in order to cover the risks that the institution is exposed to. This means that FI, in its review, must determine whether the arrangements, strategies, processes and mechanisms that the institution has implemented in order to comply with the Directive and the own funds that the institution has at its disposal in order to ensure a sound management and coverage of the risks that it is exposed to (prop. 2006/07:5 p. 342 et seq.) are adequate.

### The Capital Adequacy Act

In Chapter 2 of the Capital Adequacy Act (KaptL), it specifies what the lowest level of own funds shall always amount to. In Chapter 2, section 1, it states the minimum amount of own funds that an institution<sup>3</sup> at any point in time shall have in terms of credit risks, market risks and operational risks. According to Chapter 2, section 2, FI in certain situations should decide that an institution shall have a certain minimum amount of own funds that is larger than what is

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<sup>1</sup> In Directive 2006/49/EG it prescribes that the same shall apply for investment firms as well.

<sup>2</sup> Henceforth only LBF is mentioned; similar reference to LVPM is implied.

<sup>3</sup> KaptL applies for both credit institutions and investment firms.

required in accordance with section 1, namely if the institution does not fulfil the requirements in Chapter 6 of LBF and it is not likely that the shortcomings will be rectified within a reasonable time period.

The capital requirements in accordance with section 1 – the so-called Pillar 1 requirement – shall be calculated according to methods that are described in more detail in FI regulations, which in turn are based on detailed provisions in the Directive. The capital requirement for each and every one of the three risk areas can be calculated by applying either a basic method or – with FI’s permission – one or several more advanced methods. Different institutions can thus arrive at different Pillar 1 capital requirements in monetary terms for the same risk portfolio.

### **The assessments in Pillar 2**

According to Chapter 6 of LBF, an institution’s business shall be conducted in such a way that the institution’s ability to fulfil its obligations is not jeopardised. An institution shall therefore identify, measure, govern, internally report and have control over the risks that its business is associated with. The institution shall ensure in particular that these credit risks, market risks, operational risks and other risks combined will not lead to jeopardising its ability to fulfil its obligations. In order to meet this requirement, the institution must at least have methods that enable it to assess and maintain on an ongoing basis the amounts, types and distribution of capital that they consider adequate to cover the level of the risks to which they are or might be exposed.

FI shall conduct a SREP in which we evaluate whether the institution’s target level of capital is adequate and whether the institution has adequate methods in order to identify, measure, govern internally, report and have control over the risks that its business is associated with.

The institution itself shall evaluate its methods and assessments in order to ensure that they are comprehensive. At least once a year, the institution shall prepare an ICAAP which becomes one – of several – sources that provide the basis for FI’s work with a SREP. FI’s general guidelines for ICAAP submission (suggested format), outline in what way an institution can inform FI regarding its ICAAP and its calculations.

In other words, Pillar 2 contains assessments of both qualitative and quantitative aspects. If there are unacceptable shortcomings in any of these respects – i.e. either that the institution’s risk management is not up to standard or that the institution does not have adequate own funds to cover the total capital need – then FI will decide on an extended own funds requirement in accordance with Chapter 2, section 2 of KaptL. However, such an extended requirement shall be resorted to only if it can be assessed that less invasive measures would not be adequate, and when at the same time there are no grounds to revoke the institution’s licence.

## FI's assessment of total capital needs

As for the requirements for the amount of own funds, the question in Pillar 2 is what total capital needs can be assessed to exist when other risks are also taken into account other than those which are included in the own funds requirement contained in Pillar 1. For this assessment, there are no concrete methods prescribed in the Act so the institution itself shall develop techniques for this, taking into consideration the proportionality principle. FI shall assess whether the processes that the institution applies are reasonable. It is not a question of a formal approval of the institution's calculations, though.

FI's task of conducting a SREP derives from LBF and it is therefore a primary task to assess the total capital need for the financial corporate group<sup>4</sup>. In the cases in which the institution is included in a Group that goes beyond the definition of a financial corporate group, these other group undertakings shall not be included in the SREP. However, for the institution, it can be natural to establish its ICAAP taking into consideration the Group as a whole. In such cases, FI must then require that the institution shows how the risk assessment regarding the undertakings that are not included in the Group can be excluded from the comprehensive ICAAP. FI will, however, assess the capital situation for the Group as a whole and, in those cases in which the institution is included in a financial conglomerate, assess whether the special requirements established for own funds and risk management have been fulfilled for the conglomerate.

In other respects as well, the institution in its ICAAP can do more than what FI takes into account in its SREP. One example concerns credit risks, in which the capital requirement in Pillar 1 is based on reaching a confidence level of 99.9%. An institution, however, for market reasons may want to calculate at a higher confidence level for its target level of capital, which then involves a larger capital need. Because this is not a requirement, FI in its assessment will disregard that portion of the institution's assessed capital needs. That amount can thereby, in terms of calculation, compensate if the institution in FI's assessment has made a low calculation of the capital need in some other respect.

A similar situation exists with regard to the question of the capital need for market risk. It is not unusual that the institution in its ICAAP uses a confidence level of 99.97% and a one-year horizon. The Pillar 1 requirement, which mainly covers the trading book, is based here on a confidence level of 99.0% and a 10-day horizon if the undertakings use so-called regulated VaR. The value calculated in that way, however, is then multiplied by a factor of between 3 and 5. Therefore, FI's assessment of the market risks in the trading book and other market risks covered by a VaR model will be based on the Pillar 1

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<sup>4</sup> If there is not any Group, it will be a question of assessing the individual institution.

requirement. For other market risks, which are not covered by the Pillar 1 requirement, FI will estimate at 99.9% and a one-year horizon.

FI will strive to use a similar basis for the estimation of the capital needs for other risks as well.

A related issue is how the SREP in Pillar 2 should view the minimum capital requirement for credit risks, market risks and operational risks as decided in Pillar 1. Because the institution has great freedom to choose the methods it uses in its ICAAP, it can happen that by using other methods than in the Pillar 1 calculation, the result is a lower capital need for the same risks. The total internal capital need according to such a calculation would then be less than the total of the Pillar 1 requirement and the assessed needs for the additional risks in Pillar 2.

Such an approach, however, cannot normally form the basis for FI's assessment of the institution's capital needs in accordance with LBF. The total assessed capital needs can never be lower than the own funds requirement that applies for the risks dealt with in Pillar 1. In its internal capital planning, the institution can work with other concepts and models, but for FI's assessment of the needed capital, the Pillar 1 calculation of these three capital requirements, must be the starting point. They shall be calculated according to any of the methods found in the regulations and which the institution has been approved for. The addition must also be done as stated in the Act. Another standpoint would mean that fundamental assessments that provide the basis of the Basel 2 regulatory framework would be abandoned.

Another important question concerns the treatment of diversification effects. This subject has previously been discussed in a memorandum (2007-04-02) which is available on FI's website (only available in Swedish). The conclusion there is still valid:

“FI will carefully assess the theoretical and empirical arguments that the undertakings present in their ICAAP concerning diversification effects between various types of risk. But until FI has gained adequate experience of the new capital adequacy regulations, FI is going to take a reluctant position towards accepting reductions in the undertakings' capital needs that are based on diversification effects in excess of that which results from Pillar 1.”

Thus, in principle, all institutions will have a total capital need that exceeds the own funds requirement that is calculated in Pillar 1<sup>5</sup>. At the same time, it is not the intention that an extended formal own funds requirement will be imposed on each and every institution as a result of the provisions in Pillar 2. For institutions that draw their own conclusions that larger own funds are needed and which for their target level of capital commit to a level that can be assessed

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<sup>5</sup> Scenario 7 in appendix 1 illustrates this principle with an example.

as satisfactory in relation to the overall risk scenario, that assessment will be the result of the SREP review. No decision to raise the own funds requirement will be called for – as long as the institution in practice maintains the indicated level of capital.

### **Target level of capital, capital buffer and stress tests**

With this approach, the institution's capital planning gains a central role in the capital evaluation. There are other reasons than calculated capital needs for various specific risks that affect an institution's assessment of what is a suitable target level of capital, e.g. the rating institutions' assessments and the need to appear as sufficiently well capitalised in the view of their customers and counterparties. For such reasons, an institution's board of directors and management can find that there is a commercial basis for committing to a higher target level of capital than that indicated by other calculations.

As a principle, FI assumes as well that all institutions take into account that a certain general buffer should exist in excess of the assessed minimum level for identified risks. This can be considered to be covered by Chapter 6 of LBF in the wording that the institution should have adequate capital to also cover risks that they might be exposed to. The purpose of this buffer is that the institution shall be able to suffer certain losses without immediately dropping down to a level for own funds that is below the long-term target. Such a capital buffer can also be considered as a way to take into account the pro-cyclicality in the capital requirement for credit risks that results from the increased risk sensitivity in the system. In a boom, when the losses are small and the capital requirement for credit risks declines, the buffer should increase, while it can instead be allowed to decline in a recession when the capital requirements become larger.

The buffer should not be seen as an additional capital requirement, but should rather be reflected in the institution's capital planning or target levels of capital.

FI presumes – to a different extent depending on the size and complexity of the institution – that institutions conduct different scenario analyses or stress tests in order to assess whether they have an adequate buffer in order to handle worsened global conditions and other elements that can have a negative effect on the capital adequacy. The scenario analyses or stress tests can take into consideration, among other things, future earnings, management actions and any expansion plans.

The scenarios or stress tests should be framed in such a way that they represent to the institution the most serious global development that can be expected to occur once during 20 – 25 years, i.e. during about every fourth business cycle. The institution can also use other scenarios or stress tests that are more probable or improbable, as a complement to these.

FI will also conduct its own scenario analyses or stress tests in order to assess the reasonability of the institutions' analyses and assessed target level of capital needs.

It is the overall picture, including such considerations, that should be crucial for FI's assessment in the SREP if an institution fulfils the requirements for the amount of own funds. This therefore requires that institutions in their ICAAP clearly report what conclusions they draw from their capital planning and what level of ambition they have in terms of their target level of capital. This – the capital need declared by the board of directors – is thus what the ICAAP should primary result in. For many undertakings that operate an uncomplicated business and which maintain a low risk profile, it can probably be assumed that own funds equivalent to the capital requirement according to Pillar 1 with an addition of a moderate buffer are adequate. This is not a matter of course, however. The board of directors must always assess whether these conditions can still be considered to be fulfilled and FI must always review the reasonability of the institution's ICAAP in the SREP.

Capital is not everything either. The requirements in LBF and KaptL for risk management and transparency must be fulfilled and cannot be replaced by the institution referring to its maintenance of more capital.

### **Extended own funds requirement**

The capital assessment in Pillar 2 is based on FI and the institution under supervision having a dialogue during the process with the establishment and review of the institution's ICAAP. FI expects that the SREP review can normally lead to a conclusion that means that the target level of capital is satisfactory.

If the outcome of FI's SREP review is satisfactory, this institution is informed by a decision. If the institution then intends to carry out larger changes in its operations or if the board of directors wants to impose changed principles for the target level of capital, this must be reported to FI which will have to assess whether the capital situation can still be considered satisfactory in light of the new conditions.

If, nevertheless, a situation arises in which an institution does not fulfil the requirement for capital or otherwise does not have adequate strategies, processes and mechanisms according to FI's assessment, it can come to the point where the Authority must formally decide on a sanction measure in accordance with FI's due process and quality assurance for cases regarding imposing sanctions. Initially, this measure can consist of an order to inject additional capital, reduce the risks in some portion of the operations or to improve the institution's strategies, processes and mechanisms. If this does not provide a sufficient measure, FI can decide to establish an extended own funds requirement. Ultimately, there is the possibility to decide to revoke a licence.

## Appendix 1

### **Principle examples of conclusions of a SREP in various situations**

#### **Scenario 1**

Conditions: The institution assesses that the capital need exceeds the requirement according to Pillar 1 and the actual own funds exceed assessed capital need.

Conclusion: If FI finds that the institution has arrangements, strategies, processes and mechanisms to ensure a sound management and the own funds that the institution actually intends to maintain are at a reasonable level above the minimum requirement according to Pillar 1, a decision should be made to close the matter. It should state in the decision that FI assesses the institution's own funds together with the target level of capital that the board of directors decided as reasonable.

#### **Scenario 2**

Conditions: The institution assesses that the level for credit, market and operational risk, together with the institution's other risks, is lower than the requirement according to Pillar 1. The board of directors has decided, however, that the own funds on the whole shall exceed the requirement according to Pillar 1 by a reasonable margin.

Conclusion: If FI finds that the institution's arrangements, strategies, processes and mechanisms to ensure a sound management are reasonable and the own funds that the institution actually intends to maintain are at a reasonable level above the requirement according to Pillar 1, the matter shall be treated in accordance with scenario 1.

If, on the other hand, FI finds that the institution's methods, etc. are not reasonable or are not entirely satisfactory but that the own funds that the institution actually intends to maintain are above the requirement according to Pillar 1, the institution, in the first instance, should be given the opportunity to submit an explanation/account for the selected method, etc. If the answers are satisfactory, the case should be treated in accordance with scenario 1. If the institution cannot provide satisfactory explanations, a decision should be made to close the matter with a disciplinary reminder regarding what the institution shall rectify by the next ICAAP, i.e. a plan of action with a follow-up within a reasonable time. If the shortcomings are of a more serious nature, the matter should be handled according to scenario 3 (an order).

#### **Scenario 3**

Conditions: The institution assesses that the level for credit, market and operational risk, together with the institution's other risks, is lower than the requirement according to Pillar 1. The board of directors has decided, however,

that the own funds on the whole shall exceed or be the same size as the requirement according to Pillar 1.

Conclusion: If FI assesses that the institution cannot show that it can ensure a sound management and/or maintain actual own funds that are at an acceptable level and if the institution on its own has not taken adequate measures, we should order the institution to take the required measures to eliminate the shortcoming. If this occurs and the own funds reach an acceptable level, there is no reason to decide on an extended own funds requirement; otherwise the matter should be handled according to scenario 6.

#### **Scenario 4**

Conditions: The institution assesses that the capital need is above its actual own funds and the actual own funds are higher than the requirement according to Pillar 1.

Conclusion: If FI finds that the institution's strategies, processes and mechanisms, etc. are reasonable, the institution should be ordered to submit a report on how the capital will be increased and within what timeframe this is planned. The matter should therefore be handled according to the last paragraph in scenario 2.

#### **Scenario 5**

Conditions: The institution's own funds amount to less than the requirement according to Pillar 1.

Conclusion: If the institution's own funds are below the requirement according to Pillar 1, the institution should be ordered to raise its own funds or adapt its operation. If the order is not complied with, an assessment should be made on whether the licence should be revoked.

#### **Scenario 6**

Conditions: Passive resistance

Conclusion: If we call attention to the shortcomings and/or that the institution's own funds are too low in relation to the risks and the institution refuses to rectify the matter within a reasonable time, we should make a decision on an extended own funds requirement in accordance with Chapter 2, section 2 of KaptL. This does not apply, however, if the shortcomings are so serious that the licence should be revoked. – The concept of reasonable time should be considered in relation to the type and degree of existing shortcomings.

#### **Scenario 7**

Conditions: The institution has assessed that a lower capital requirement shall apply for certain risks and a higher requirement for other risks, compared with Pillar 1.

Conclusion: The highest<sup>6</sup> capital requirement according to Pillar 1 or the institution's assessed capital need *per risk* should provide the basis for the comprehensive capital need according to FI. The board of directors shall decide on a lowest own funds amount that exceeds this.

	Pillar 1	ICAAP	SREP
Credit risk	44	11	44
Market risk	6	13	13
Operational risk	35	35	35
Concentration risk	-	9	9
Total	85	68	101

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<sup>6</sup> This assumes that FI does not conclude that the institution's assessed capital need for a particular risk should be adjusted (up or down), which can be the case, for example when the institution has selected a different confidence level than that which applies in Pillar 1.

## Appendix 2

### **Glossary**

*Own funds* are the amount of eligible own funds items that the institution actually maintains. Provisions on how to calculate own funds can be found in Chapter 3 of KaptL. This definition applies to both Pillars 1 and 2.

*The own funds requirement* is that which in Chapter 2, sections 1-2 of KaptL is stipulated as the minimum amount for own funds. If the institution does not fulfil this requirement, then it shall be ordered to rectify this shortcoming.

In Chapter 2, section 1, it states that the own funds shall be at least equivalent to the total of that which the law prescribes as the *minimum capital requirements* for credit risk, for market risks and for operational risks (total capital requirement for the Pillar 1 risks).

In Chapter 2, section 2, there is the alternative with an *extended own funds requirement*, i.e. a minimum amount of own funds specially decided by FI, larger than what is required in accordance with the calculation found in section 1. Because the specially decided own funds requirement shall be fulfilled at all times, it must be a question of some formula in order to calculate the amount in question when the portfolio changes in size and composition. It is FI's task to express the extended requirement in a way that suits the circumstances in the individual matter.

The terms capital requirement and own funds requirement are connected with the established regulations in Pillar 1, where the amount in principle is calculated exactly and in which the question of whether the requirements have been fulfilled can be answered unambiguously. In contrast to this, the term capital need refers to an assessed amount and is used in connection with risks that are not treated in Pillar 1.

*Capital need* is the estimate concluded in the Pillar 2 assessment of an individual risk<sup>7</sup>. The total<sup>8</sup> of all individual capital needs in Pillar 2, together with the capital requirements for Pillar 1's risks, provides the assessed *comprehensive capital need*. When needed, it may be specified if it refers to the institution's or FI's assessment.

*Target level of capital* refers to the intended level of own funds that the board of directors has decided on.

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<sup>7</sup> It should not be taken for granted that all risks that an institution accounts for in its ICAAP are such that they lead to a specified capital need.

<sup>8</sup> For Pillar 2 risks, it should not be taken for granted that it is a question of a simple sum of parts; the institution may be allowed in that case to use other correlation assumptions if it appears reasonable.

*Buffer* refers to a margin in excess of the assessed comprehensive capital need which the institution maintains in order to obtain a free hand should unexpected events arise. The buffer can also have a function to dampen the pro-cyclicality in the capital requirement for credit risk which results with increased risk sensitivity.