



# Common Criteria and Methodologies for SREP

5<sup>th</sup> edition

February 2020



FJÁRMÁLAEFTIRLIT

## Contents

Disclaimer .....	3
1. Introduction .....	3
2. Supervisory Review and Evaluation Process (SREP) .....	4
2.1 General .....	4
2.2 Categorisation of institutions .....	4
2.3 Monitoring of key risk indicators.....	5
2.4 Assessment of risks.....	5
2.4.1 Analysis of business models .....	6
2.4.2 Assessment of internal governance and institution-wide controls.....	6
2.4.3 Assessment of risks to capital.....	7
2.4.4 Assessment of risks to liquidity and funding .....	9
2.5 Overall SREP assessment and application of supervisory measures.....	10
2.6 Scoring.....	10
3. FSA capital requirements .....	11
3.1 General .....	11
3.2 Pillar II-R: The FSA's assessment of capital requirements for risks.....	11
3.2.1 General.....	11
3.2.2 Total SREP Capital Requirement .....	13
3.3 Pillar II-G: Capital guidance to meet stressed conditions .....	13
3.4 Capital buffers.....	13
3.5 Overall capital requirement and supervisory measures for insufficient capital .....	14
3.6 Decision letters and publication of the FSA's assessment of capital needs.....	15

## Disclaimer

This English version is a translation of the original Icelandic document (*Almenn viðmið og aðferðafræði vegna könnunar- og matsferlis hjá fjármálafyrirtækjum, 5. útgáfa*). In case of any discrepancy, the original Icelandic text prevails.

## 1. Introduction

Institutions are required to operate a secure risk management system, cf. Article 17 of the Act on Financial Undertakings, no. 161/2002, and must address risks in their operations in accordance with Articles 78(a)–78(i) of the same Act. The board of directors and managing director of an institution shall regularly assess the level, composition, and distribution of the institution's capital needs based on its level of risk, cf. Article 80, Paragraph 1 of Act no. 161/2002. This process is carried out via the Internal Capital Adequacy Assessment Process (ICAAP) and Internal Liquidity Adequacy Assessment Process (ILAAP), results of which relevant institutions report annually.

The Financial Supervisory Authority of the Central Bank of Iceland (FSA) assesses the risks inherent in the activities of an institution via the Supervisory Review and Evaluation Process (SREP), in accordance with Articles 80 and 81 of Act no. 161/2002, cf. Article 86 (g) of the same Act. During the SREP, the Authority also evaluates how relevant institutions address risks in their operations, cf. Article 79 of Act no. 161/2002, including with reference to the ICAAP and ILAAP reports. A comprehensive SREP is performed every one, two, or three years, depending on the size and nature of the institution and its activities. However, certain key risks are assessed annually, and key risk indicators are monitored at least every quarter.

The purpose of this document is to define and describe the criteria, procedures, and methodologies applied in the FSA's assessment of relevant institutions' overall risk level and need for capital; i.e., SREP.<sup>1</sup> The methodologies are in accordance with the European Banking Authority's [Guidelines on Common Procedures and Methodologies for SREP, with later amendments](#). The EBA Guidelines contain a more detailed description of the methodologies the Authority applies.

Chapter 2 gives an overview of the methodologies applied in the SREP, describing how institutions are categorised according to size and significance, how key risk indicators are monitored, how assessment for individual risks is carried out, how overall risk assessment is conducted, how supervisory measures are structured, and how the SREP scores are determined. Chapter 3 articulates, among other things, the FSA's assessment of capital requirements, the setting of capital buffers, and supervisory measures for insufficient capital.

In addition to these common criteria and methodologies, the Authority has published three Annexes. Annexes 1 and 2 provide descriptions of the FSA's supervisory benchmarks and supervisory calculations on credit and concentration risk<sup>2</sup> and market risk.<sup>3</sup> Annex 3 describes the capital buffers.<sup>4</sup> Annexes are not published for other risks, such as operational risk, as it is difficult to define quantifiable benchmarks for capital needs in advance. Publication of these criteria and procedures is in accordance with the Authority's transparency policy; however, these publications do not disclose all details of the methodologies used by the FSA. For example, the complete list of variables for the categorisation of institutions is disclosed, nor

<sup>1</sup> The criteria and methodologies described in this document are an addition to information that the FSA has published pursuant to [Art. 116\(a\) of Act No 161/2002](#) (in Icelandic).

<sup>2</sup> Annex 1: Supervisory benchmarks for the setting of Pillar 2 additional own funds requirements for credit and concentration risk.

<sup>3</sup> Annex 2: Supervisory benchmarks for the setting of Pillar 2 additional own funds requirements for market risk.

<sup>4</sup> Annex 3: Capital buffers.

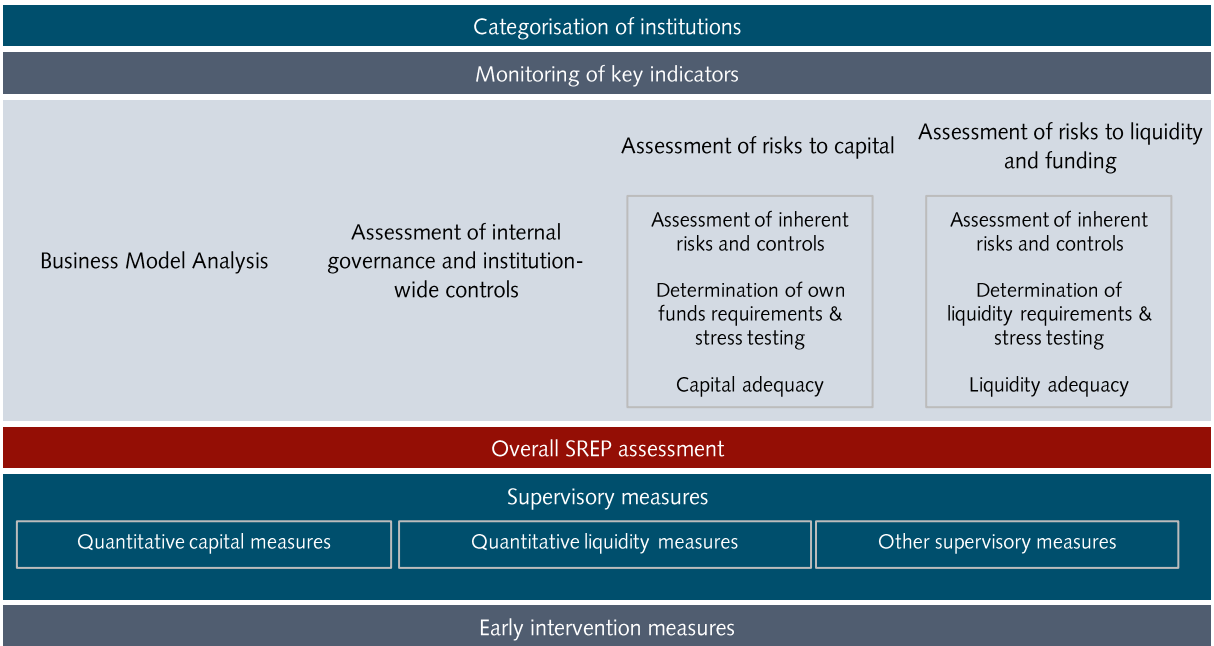
are individual SREP scores, as such disclosure could increase the probability of regulatory arbitrage and, in some cases, counteract the use of supervisory judgment in the SREP.

## 2. Supervisory Review and Evaluation Process (SREP)

### 2.1 General

The table below (Figure 1) gives an overview of the common SREP framework. Chapters 2.2-2.6 describe the different elements of the SREP found in the following table.

Figure 1: The SREP framework



### 2.2 Categorisation of institutions

The FSA applies the principle of proportionality in its supervisory activities; that is, it categorises institutions based on their size, structure, and complexity, with the aim of prioritising its supervisory oversight and engagement. For this purpose, the Authority divides institutions into four impact categories.

The categorisation of institutions by impact is based on a model using parameters defined by the FSA. The values are collated from regularly reported data provided to the FSA, inspections, and other relevant information acquired by the FSA.

The parameters of the model reflect the five elements of the impact assessment: *size*, *interconnectedness*, *substitutability*, *complexity*, and *scope of international activities*.

Table 1: Impact categorisation of institutions

Impact category of institutions	Description
High impact	Institutions that could threaten financial stability when ailing or failing.
Medium-high impact	Institutions that do not threaten financial stability when ailing or failing but could have a significant effect on the economy and large groups of customers.
Medium-low impact	Institutions that generally do not affect the financial system if ailing or failing but could have a significant effect on customers.
Low impact	Institutions that have minimal effect on the financial system, and only a small group of customers will be affected when they are ailing or failing.

To ensure appropriate supervision of all institutions, the FSA has defined the *minimum-engagement model* describing the nature and frequency of the supervisory engagement for each impact category. The minimum-engagement model generally indicates the supervisory engagement necessary to provide an overview of all risks in the activities of an institution. Therefore, the assessment of key risks is carried out more frequently for institutions categorised as *high-impact* than for institutions in lower impact categories. Generally, the nature of inspections and the time allotted to them are determined by impact category and the nature of the institutions' activities.

## 2.3 Monitoring of key risk indicators

In addition to observing financial market developments, the FSA monitors key risk indicators of relevant institutions on at least a quarterly basis. Monitoring of key risk indicators is based primarily on regularly reported data, and it can indicate changes in risk or exposure in the activities of institutions, or indicate risks that warrant further enquiry. The FSA regularly reviews the key risk indicators monitored. Key risk indicators of the FSA are based, among other things, on the [common risk indicators of the EBA](#).

## 2.4 Assessment of risks

The FSA performs risk assessment for key risks in the activities of relevant institutions. Generally, the assessment is updated every quarter with respect to the key risk indicators, but more frequent assessment is carried out if necessary.

The risk assessment is performed with inspections and data analysis that can identify risk in the operations of institutions and can be directed either at individual risks in specific institutions or in multiple institutions simultaneously. The risk assessment utilises, among other things, regularly reported data, results of off-site inspections, and results of on-site inspections.

Assessment of individual risks is based on the inherent risk and the risk management systems that exist within the institution. Thus the risk assessment is intended to assess the underlying risks in the activities of an institution, taking into consideration the actions taken by the institution to counteract or minimise that

risk. Scores are assigned to individual risks as a result of the risk assessment (see Chapter 2.6 below for further discussion of the scores).

### 2.4.1 Analysis of business models

The business model analysis aims to identify possible threats to the viability<sup>5</sup> of the business model and the sustainability<sup>6</sup> of the overall strategy of the institution. The business model and overall strategy are evaluated based on the risk appetite of the institution and its performance in recent years. Assumptions for expected developments in income, costs, and capital are reviewed and evaluated.

The analysis is based on the business model of the institution, the ICAAP report, regularly reported data, and other data requested by the FSA. The data are compared to results of previous SREPs and the business models of other institutions. The analysis is supported and guided by an EBA supervisory handbook for business model analysis. The institutions' position in the current business environment is evaluated, its financial statement is analysed, and various qualitative and quantitative aspects of the business model are assessed. The FSA also uses stress testing to determine the impact of a baseline scenario on an institution's income statement and balance sheet, and to determine whether its own funds are sufficient to meet the overall capital requirement over the forecast period (see Chapter 3.3 below).

### 2.4.2 Assessment of internal governance and institution-wide controls

An assessment of internal governance and institution-wide control includes whether the internal governance of an institution fulfils the requirements for proper governance and internal control and whether the institution's governance is proportional to its risk appetite, business plan, nature, scope, and activities. Particular attention is given to whether the institution's internal governance arrangements ensure sound management of risks and include appropriate internal controls. In this evaluation process, consideration is given to whether governance and internal control generate risks and affect the viability of the institution. The assessment includes the following areas:

- The overall internal governance framework,
- the composition, organisation, and functioning of the management body and its committees, where established,
- corporate and risk culture,
- remuneration policies and practices,
- the internal control framework, which should include a clear organisational structure and well-functioning independent internal risk management, compliance, and audit functions,
- the risk management framework, including ICAAP, ILAAP, and new product approval process,
- administrative and accounting procedures,
- outsourcing arrangements,
- information systems and business continuity, and
- consistency and credibility of recovery planning.

However, the assessment does not include risk management and internal control related to individual risks.

The assessment is based on the institution's ICAAP report; regularly reported data and other information;

---

<sup>5</sup> Viability of the business model: Ability to generate sufficient returns over the short term (next 12 months).

<sup>6</sup> Sustainability of the overall strategy: Ability to generate sufficient returns over the long term (at least 3-year projection).

interviews with the institution's board members, directors and other employees; and information acquired from on-site inspections. In this assessment, the FSA uses [EBA's Guidelines on internal governance of institutions](#) and [fit and proper](#) and other recognised guidelines<sup>7</sup> and guidance on corporate governance.

### 2.4.3 Assessment of risks to capital

Risk assessment of critical risks that affect institutions' own funds is performed systematically. Inherent risk is assessed, and the standard of risk management and internal control is evaluated for all relevant risks. The following risks are evaluated with regard to, among other things, estimated own funds requirements:

#### ***Credit, counterparty, and concentration risk<sup>8</sup>***

According to Article 78(a) of Act no. 161/2002, institutions should apply their own methodologies when assessing credit and counterparty risk arising from exposures relating to individual borrowers, securities, securitised exposures, and their entire credit portfolios. Additionally, pursuant to Article 78(c) of the same Act, institutions shall assess and manage concentration risk arising from individual counterparties within the same sector of the economy, the same geographical area, or the same industry. Furthermore, institutions shall, with documented plans and procedures, manage the remaining risks if measures for credit risk mitigation prove insufficient; cf. Article 78(b) of Act no. 161/2002.

Credit risk is the risk of losses arising from a borrower's failure to make required payments as they fall due. Counterparty risk refers to the risk of loss because the counterparty to a derivatives trade, securities loan, or a repurchase agreement does not fulfil its obligations in accordance with the agreed terms. Concentration risk refers to the risk of loss due to insufficient distribution of the credit portfolio; it is divided into *single-name*, *sectoral*, and *geographical risk*.

When assessing credit and counterparty risks, the FSA focuses on the institution's inherent risk and its risk management. Among other things, the FSA evaluates the following:

- composition/distribution of the credit portfolio,
- default rates and their management,
- cancellation of debt and the methodology used for debt cancellation, and
- risk mitigation and risk management.

In assessing the inherent concentration risk of an institution, the FSA considers risk that results from a small number of exposures, or exposures that have similar characteristics with reference to default and how the institution manages said default. The assessment includes an analysis of the possible correlation of default, particularly under stressed conditions. It also includes credit borrower concentration; single-name risk and geographical risk; product diversification; and concentration of guarantors and collateral.

The FSA regularly requests that institutions submit data and information on own funds and other balance sheet items in order to assess credit risk, counterparty risk, and concentration risk. The FSA also acquires additional information for use in the evaluation process; for example, in order to verify data and information acquired from the institutions concerned.

---

<sup>7</sup> For example, [Guidelines on outsourcing arrangements \(EBA/GL/2019/02\)](#) og [Guidelines on ICAAP and ILAAP information collected for SREP purposes \(EBA/GL/2016/10\)](#).

<sup>8</sup> See Annex 1: Supervisory benchmarks for the setting of Pillar 2 additional own funds requirements for credit and concentration risk.

**Market risk<sup>9</sup>**

According to Article 78(e) of Act no. 161/2002, relevant institutions shall have documented plans and procedures to analyse, assess, and manage all significant factors that cause or influence market risk and its effects. Market risk is the risk of loss of value due to factors that affect the overall performance of the financial markets.

The FSA assesses institutions' inherent market risk and management of market risk, both in the trading book and in the banking book. Additionally, the FSA assesses the following risk sub-categories using its own criteria, which are based, among other things, on sensitivity analysis and VaR analysis in accordance with the [EBA Guidelines on Stressed Value at Risk](#):

- interest rate risk,
- equity risk,
- FX risk, and
- price indexation risk.

The FSA regularly requests that institutions submit data and information on own funds and other balance sheet items in order to assess market risk. The FSA also acquires additional information for use in the evaluation process; for example, in order to verify data and information received from the institutions concerned.

**Interest rate risk in the banking book (IRRBB)**

According to Article 78(g) of Act no. 161/2002, relevant institutions shall analyse, assess, and manage the risk that potential interest rate changes will affect their transactions outside the trading book.

Interest rate risk in the banking book, or IRRBB, refers to prospective risk to the institution's capital and earnings, arising from adverse movements in market interest rates that affect the institution's banking book positions.

The FSA assesses the standard of an institution's management of IRRBB. The impact of sudden upward and downward parallel shifts of the relevant yield curves (applying a 0% floor) is assessed in accordance with the [EBA Guidelines on the management of interest rate risk arising from non-trading book activities](#). The impact of these shifts on the present value of interest-bearing assets and liabilities in each currency is the basis for the FSA's risk assessment.

The FSA regularly requests that institutions submit data and information on own funds and other balance sheet items in order to assess IRRBB risk. The FSA also acquires additional information for use in the evaluation process; for example, to verify data and information received from the institutions concerned.

**Operational risk**

Pursuant to Article 78(g) of Act no. 161/2002, relevant institutions shall have documented plans and procedures to assess and manage operational risk, including risk stemming from risk models and from rare events that may have material impact. Operational risk is the risk of losses stemming from inadequate or failed internal processes, people, and systems, or from external events.

Sub-categories of operational risk include:

- compliance risk,
- conduct risk,

---

<sup>9</sup> See Annex 2: Supervisory benchmarks for the setting of Pillar 2 additional own funds requirements for market risk.



- legal and political risk,
- model risk,
- information technology risk, and
- reputational risk.

The FSA assesses inherent operational risk, centred on the sub-categories mentioned above and other risks deemed to be of particular interest, and the management and control of these risks within the institution.

The FSA regularly requests that institutions submit data and information on own funds and other balance sheet items in order to assess operational risk. The FSA also acquires additional information for use in the evaluation process; for example, in order to verify data and information received from the institutions concerned.

#### 2.4.4 Assessment of risks to liquidity and funding

Institutions must at all times have sufficient liquid assets available to fulfil minimum or average liquidity requirements in order to meet payment obligations, including withdrawals of deposit funds, and to cover any possible imbalance between liquidity inflows and outflows under stressed conditions over a specific period; cf. Article 83 of Act no. 161/2002.<sup>10</sup> Institutions shall strive to ensure diverse and stable funding; e.g., to limit maturity mismatches between assets and liabilities. Institutions are also required to formulate and implement strategies, policies, documented procedures, methods, and systems to analyse, assess, and control liquidity and funding risk; cf. Article 78(h) of the same Act.

The FSA's assessment of an institution's liquidity and funding needs is an integral part of the SREP; cf. Article 79, Paragraph 2 and Article 81, Paragraph 2 of Act no. 161/2002. The assessment is based on three factors: first, an assessment of liquidity and funding risk management; second, an assessment of inherent liquidity risk; and third, an assessment of inherent funding risk.

The assessment of liquidity and funding risk management includes evaluation of the liquidity strategy and whether the institution operates under approved policies, procedures, and controls. The assessment also includes an evaluation of stress tests, contingency plans, and funding plans.

The assessment of inherent liquidity risk includes an evaluation of liquidity needs in the short and medium term, intraday liquidity risk, liquidity buffers, counterbalancing capacity and supervisory liquidity stress testing.

The assessment of inherent funding risk addresses the institution's funding profile and stability, evaluates potential threat to financial stability stemming from the funding profile, and examines the institution's market access and the expected change in funding risks with reference to the institution's funding plan.

The FSA's assessment of the above-mentioned factors is based in particular on [FSA Guidelines No 2/2010 on best practice of liquidity management](#) (in Icelandic), ICAAP and ILAAP reports, regularly reported data, on-site inspections, and other information that may be relevant to evaluate liquidity and funding risks and is considered essential to the completion of the assessment.

The outcome of the assessment may lead to specific liquidity requirements and requests for improved management and control of the risks in question. The outcome may also lead to requirements that the institution extend maturities, acquire additional own funds, reduce off-balance-sheet exposures, and so forth.

---

<sup>10</sup> See also [Rules No 266/2017 on liquidity ratios of credit institutions](#) (in Icelandic) and [Rules No 1032/2014 on funding ratios in foreign currencies](#).

## 2.5 Overall SREP assessment and application of supervisory measures

In the annual overall SREP assessment, results of individual risk evaluations are collected and aggregated. An overall SREP assessment is completed for all relevant institutions regardless of the frequency or detail of individual risk evaluations during the process. The overall SREP assessment is reflected in a risk score (see Chapter 2.6 below).

After the completion of the overall SREP assessment, the FSA engages in dialogue with the institution and stipulates corrective actions for that institution. Supervisory measures may include own funds measures, liquidity measures, and other supervisory measures. Corrective actions are considered administrative measures pursuant to the Administrative Procedures Act, no. 37/1993, and are formally reported to the institution (see Chapter 3.6 below).

## 2.6 Scoring

Scores are attached to individual risks and to the overall SREP assessment. The FSA uses the scores in a number of ways, including to prioritise projects and engagement, and considers them a part of its risk-based supervisory architecture. However, the scores do not directly affect specific requirements for corrective actions (for instance, own funds requirements), and they are not disclosed to individual institutions. The rating scale is from one to four (see Table 2).

**Table 2: Risk scores overview**

SREP score	Description
1	Minimal risk identified.
2	The risk identified is limited, but performance could be improved. Necessary to monitor possible weaknesses in the operations of the institution.
3	Medium-to-high levels of risk identified in the operation of the institution. Necessary to observe and monitor the institution and insist on corrective actions.
4	Very high levels of risk identified in the operations of the institution. Necessary to engage, use supervisory measures, and insist on immediate corrective actions.

The overall risk assessment can also result in a negative score of 'F', indicating that the institution is 'failing or likely to fail'. A negative score may result in early intervention measures pursuant to Article 86(h) of Act no. 162/2002 or measures pursuant to Chapter XII and Temporary Provision VI of the same Act.

### 3. FSA capital requirements

#### 3.1 General

The FSA's decision on additional own funds requirements under Pillar II is twofold:<sup>11</sup>

- Pillar II capital requirements (P2R) for risks; that is, the risk of expected losses and unexpected losses insufficiently covered by Pillar I,<sup>12</sup> over a 12-month period.
- Pillar II capital guidance (P2G) to meet stressed conditions; that is, possible risk of losses that are caused by adverse conditions over the economic cycle and are not covered sufficiently under Pillar I and Pillar II requirements or relevant capital buffers.

#### 3.2 Pillar II-R: The FSA's assessment of capital requirements for risks

##### 3.2.1 General

According to Article 84, Paragraph 1 of Act no. 161/2002,<sup>13</sup> a relevant institution's own funds must equal at least 8% of its total risk exposure amount.<sup>14</sup> The board of directors and managing director of an institution shall regularly assess the level, composition, and distribution of the institution's capital needs based on its level of risk; cf. Article 80, Paragraph 1 of Act no. 161/2002. The assessment is carried out internally and submitted as an ICAAP report to the FSA.

The FSA evaluates risks relevant to the capital needs of institutions in accordance with Articles 79-81 of Act no. 161/2002; cf. Article 86(g) of the same Act. The FSA's assessment relies mainly on data regularly reported to the FSA, particularly to include ICAAP reports, financial statements, and internal audit reports. The FSA also gathers further information through dialogue with institutions and through specific inspections during the SREP.

The FSA's evaluation reflects how adequate the measures taken by the institution are, whether management is sound, and whether own funds maintained are sufficient, given the level of risk entailed in the institution's activities. The FSA's conclusion may result in supervisory engagement, where the FSA may enforce the following supervisory measures under Article 86(g), Paragraph of Act no. 161/2002:

- a. requiring own funds equalling more than 8% of the total risk exposure amount, cf. Chapter 3.2.2 below,
- b. requiring improvements to internal processes,
- c. requiring institutions to present a plan to restore compliance with the requirements of the Act, as well as the regulations and rules deriving from the Act,
- d. requiring a write-down of assets forming eligible own funds,
- e. restricting or limiting the institution's activities, or forcing it to sell assets or components of the

<sup>11</sup> Pursuant to Article 86(g), Paragraph 7 of Act no. 161/2002, the Pillar II capital maintained must comprise at least 56.25% CET1 capital and 75% Tier 1 capital.

<sup>12</sup> Pillar I is the minimum own funds requirement; that is, eligible own funds maintained at least 8% of total risk exposure amount, cf. Article 84, Paragraph 1 of Act no. 161/2002. Pillar I eligible own funds shall be comprised of Tier 1 capital, cf. Articles 84(a) and 84(b); Tier 2 capital, cf. Article 84(c), net of deductions, pursuant to Article 85. Of that amount, CET1 capital net of deductions shall equal at least 4.5% of the total risk exposure amount, and Tier 1 capital net of deductions shall equal at least 6% of the total risk exposure amount.

<sup>13</sup> See also [Regulation No 233/2017](#) (in Icelandic).

<sup>14</sup> The total risk exposure amount is the aggregate of weighted risks, such as credit risk, equity risk, interest rate risk, currency risk and operating risk, inherent in the institution's activities, cf. Article 84(e) of Act no. 161/2002.

business that entail higher risks to the institution,

- f. requiring a reduction of the risk entailed by the institution's activities, certain products, or systems,
- g. limiting bonuses as a percentage of net profits, as their payment will lead to insufficient own funds,
- h. requiring net profits to be allocated to strengthen own funds,
- i. limiting or prohibiting payments of dividends and interest to shareholders and investors,
- j. imposing specific liquidity requirements, including restrictions on maturity mismatches between assets and liabilities,
- k. requiring increased data reporting, and
- l. requiring *ad hoc* disclosure to the market.

In addition, the FSA may comment and propose action in accordance with Article 10, Paragraph 1 of the Act on Official Supervision of Financial Activities, no. 87/1998.

For the determination of additional own funds requirements to cover the risk of unexpected losses, the FSA completes a comprehensive assessment of individual risks, supported by the following sources of information:

- a. ICAAP calculations,
- b. outcome of supervisory benchmark calculations,<sup>15</sup> and
- c. other relevant input, including that arising from interaction and dialogue with the institution.

In an effort to ensure the quality of the FSA's evaluation of individual risks affecting own funds, the FSA has developed risk-specific supervisory benchmarks for certain subcategories of individual risks. However, the FSA emphasises that institutions should develop and apply their own detailed criteria and methodologies for the evaluation of inherent risk. If the FSA considers the institution's own criteria and methodologies sufficient and appropriate, the FSA favours them proportionally to support the determination of own funds.<sup>16</sup> If the FSA considers the institution's own criteria and methodologies insufficient or inappropriate, however, the FSA will favour its own supervisory benchmarks and judgement to support the determination of additional own funds. The FSA's results are not meant to substitute for the institution's own assessment of inherent risk; rather, it is vital that the institution evaluate the risks of its activities in a sufficient manner.

For Pillar I risks, the minimum own funds requirements represent a floor on a risk-by-risk basis, and additional own funds under Pillar II should be assessed for those risks or elements not covered by Pillar I requirements. Own funds held to cover the minimum own funds requirements under Pillar I should not be used to meet or offset the additional own funds requirements under Pillar II. In the FSA's assessment and determination of additional own funds requirements, risk diversification effects arising from individual risks, such as credit and concentration risk, market risk, or operational risk (inter-risk diversification) do not reduce the minimum own funds requirements. However, the FSA may assess and consider diversification effects arising from risk drivers within each risk category (intra-risk diversification) and comprehensively evaluate own funds requirements for each risk. For the assessment of capital requirements, the FSA uses year-end financial information. Although the decision on capital adequacy requirements is not made until at least half a year later, changes in developments in individual risk sub-categories are not taken into account unless the overall impact of all sub-categories leads to a significant increase or decrease in capital requirements.

<sup>15</sup> For further information, see Annexes.

<sup>16</sup> *Sufficient* refers to whether the methodology is statistically strong and sensible. *Appropriate* refers to whether the methodology covers the risks most appropriate in every instance. In its assessment, the FSA will, among other things, evaluate whether the institution's methods can be considered detailed, credible, understandable, and comparable.

This applies to all risks to capital.

### 3.2.2 Total SREP Capital Requirement

Total SREP Capital Requirement refers to the sum total of the minimum capital requirement - that is, eligible own funds of 8% of the total risk exposure amount pursuant to Article 84, Paragraph 1 of Act no. 161/2002 - and additional own funds requirements determined by the FSA. The decision is made with reference to Article 86(g), Paragraph 4, Point (a) of Act no. 161/2002, which states that the FSA is authorised to prescribe eligible own funds higher than 8% of the total risk exposure amount. In such cases, the institution is always required to hold sufficient eligible own funds to meet the FSA's requirement.

### 3.3 Pillar II-G: Capital guidance to meet stressed conditions

Relevant institutions are required to address their need for own funds to meet stressed conditions in their capital planning framework, risk management efforts, and recovery planning. Additionally, institutions shall operate so as to meet their expected capital needs under stressed conditions.

The FSA will assess the adequacy of the institution's own funds to cover possible volatility and shocks in stressed conditions. The assessment is based on the results of supervisory stress tests. Furthermore, the FSA reviews the results of stress tests carried out by other supervisory bodies and the ICAAP stress test carried out by the institution itself (own scenario).<sup>17</sup>

The FSA's supervisory stress testing assesses the sensitivity of the institution's Common Equity Tier 1 (CET1) ratio and Total Risk Exposure Amount (TREA) under the adverse scenarios over the forecast period. Additionally, the impact of stress tests on the institution's leverage ratio is assessed and considered.

When outcomes of supervisory stress tests suggest that an institution's CET1 ratio is expected to fall below the capital conservation buffer - and, under extraordinary circumstances, below the countercyclical capital buffer as well - the FSA may set additional capital guidance to meet stressed conditions (Pillar II-G), which is not a part of the Overall Capital Requirement (OCR). When assessing the institution's capital adequacy in stressed conditions, the FSA considers plans for credible management actions intended to mitigate the impact on the institution's own funds. The FSA assesses the CET1 ratio during the worst year of stress and the composition of the institution's OCR at that point in time.

If an institution's eligible own funds held for the purposes of meeting stressed conditions do not meet the capital guidance of the FSA, additional supervisory measures may be considered, including increased supervision or additional capital requirements (Pillar II-R) under extraordinary circumstances.

### 3.4 Capital buffers

Pursuant to Article 86(a) of Act no. 161/2002, relevant institutions shall, in addition to the minimum capital requirement, maintain the following capital buffers in accordance with Articles 86(b)-86(e) of the same Act:<sup>18</sup>

1. Systemic risk buffer
2. Capital buffer for other systemically important institutions (O-SII buffer)
3. Countercyclical capital buffer

<sup>17</sup> [Guidelines on institutions' stress testing \(EBA/GL/2018/04\)](#).

<sup>18</sup> Capital buffers may only be met with CET1 capital, pursuant to Article 84(a) of Act no. 161/2002, cf. Article 86(a) of the same Act.

#### 4. Capital conservation buffer

The Central Bank of Iceland (CBI) shall issue rules on the systemic risk buffer, the O-SII buffer, and the countercyclical capital buffer, subject to approval by the Bank's Financial Stability Committee. The capital conservation buffer is added to individual institutions' capital requirement in accordance with Act no. 161/2002.<sup>19</sup>

### 3.5 Overall capital requirement and supervisory measures for insufficient capital

If an institution does not meet the overall capital requirement - that is, the FSA's minimum capital requirement in addition to the combined buffer requirement, cf. Article 86(a) of Act no. 161/2002 - the allocation of profits, as well as the payment of bonuses and dividends, is limited cf. [FSA Rules No 1270/2015 on maximum outbound payments and limits to outbound payments by cause of capital buffers](#) (in Icelandic). Additionally, under these conditions, the board of directors of the relevant institution must provide the FSA with documentation describing how the institution will conserve own funds, cf. Article 86(f).

Article 86(b), Paragraph 4 of Act no. 161/2002 states that if an institution does not meet the requirement for the maintenance of own funds above the systemic risk buffer, and if limits on outgoing payments pursuant to Article 86(a), Paragraph 6 of the Act are considered insufficient to strengthen the institution's own funds, the FSA may enforce the following supervisory measures:

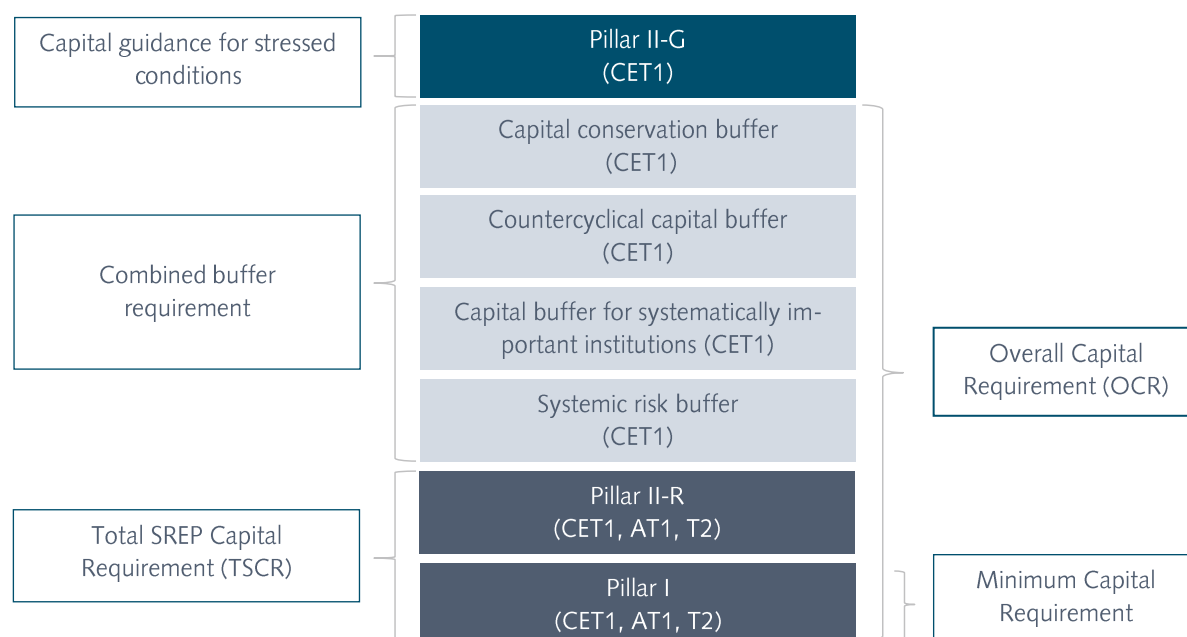
1. Revoke the institution's operating licence, partially or in full, pursuant to Article 9, Paragraph 1, Point 10.
2. Require corrective actions pursuant to Article 86(g), Paragraph 4.
3. Impose specific liquidity requirements.

If an institution does not meet the FSA's minimum capital requirements - i.e., eligible own funds equalling 8% of the total risk exposure amount, cf. Article 84, Paragraph 1 of Act no. 161/2002, and additional own funds requirements determined by the FSA, cf. Article 86(g), Paragraph 4, Point (a) of the same Act - the institution must inform the FSA accordingly, cf. Article 86 of the Act. The FSA may, by further decision, grant the institution a period of up to 6-12 months to meet the requirements. If measures taken to meet the requirements prove inadequate, the institution's operating licence may be revoked, cf. Article 9 of the Act, and then early intervention measures, cf. Article 86(h) of the Act, or measures pursuant to Chapter XII and Temporary Provision VI of the Act, may be considered.

---

<sup>19</sup> See Annex 3: Capital buffers.

Figure 2: Stacking order of own funds requirements



### 3.6 Decision letters and publication of the FSA's assessment of capital needs

The FSA informs an institution of the SREP results with a decision letter, following dialogue and after giving the institution an opportunity to express its views on the decisions; cf. the Administrative Procedures Act, no. 37/1993.

The letter contains the FSA's decision on the Total SREP Capital Requirement and is broken down into the following risks:

- a. credit, counterparty, and concentration risk,
- b. market risk and IRRBB, and
- c. other risks; i.e., operational risk, etc.

The letter also specifies the main risk drivers within each risk and, in some cases, lists supervisory measures pursuant to Article 86(g), Paragraph 4 of Act no. 161/2002 that the FSA may consider because of the SREP. In addition, the letter includes the Overall Capital Requirement.

The FSA publishes a transparency announcement<sup>20</sup> summarising the main results of the SREP, including the Total SREP Capital Requirement and the Overall Capital Requirement.

<sup>20</sup> Cf. Art. 9(a) of Act No 87/1998 and the FSA's transparency policy (in Icelandic).