Common Criteria and Methodologies for SREP

4th edition

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FJÁRMÁLAEFTIRLITIÐ
THE FINANCIAL SUPERVISORY AUTHORITY, ICELAND

Contents

Disclaimer

This English version is a translation of the original Icelandic document (*Almenn viðmið og aðferðafræði vegna könnunar- og matsferlis hjá fjármálafyrirtækjum, 4. útgáfa*). In case of any discrepancy, the Icelandic original text will prevail.

1. Introduction

Institutions are required to operate a secure risk management system, cf. Art. 17 of Act No 161/2002 on Financial Undertakings, and must address risks in their operations in accordance with Art. 78 (a) – Art. 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. Par. 1 of Art. 80 of Act No 161/2002. This process is carried out in the Internal Capital Adequacy Assessment Process (ICAAP) and Internal Liquidity Adequacy Assessment Process (ILAAP), results of which relevant institutions report to the Financial Supervisory Authority (FME) annually.

The FME assesses the risks inherent in the activities of an institution in the Supervisory Review and Evaluation Process (SREP), in accordance with Art. 80 and 81 of Act No 161/2002, cf. Art. 86 (g) of the same Act. During the SREP, the Authority also evaluates how relevant institutions address risks in their operations, cf. Art. 79 of Act No 161/2002, among other things, with reference to the ICAAP and ILAAP reports. A comprehensive SREP is either performed annually, biannually or every 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 FME's assessment of relevant institutions' overall risk level and need for capital, i.e. SREP.[1] The methodologies are in accordance with the European Banking Authority's *Guidelines on Common Procedures and Methodologies for SREP, with later amendments*[2]. 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, overall risk assessment, supervisory measures and how the SREP scores are determined. Chapter 3 articulates, among other things, the FME'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 FME's supervisory benchmarks and supervisory calculations on credit and concentration risk[3] and market risk.[4] Annex 3 describes the methods used for the setting of capital buffers.[5] Annexes are not published for other risks, such as operational risk, as it is difficult to define calculable benchmarks for capital needs in advance. Publication of these criteria and procedures is in accordance with the Authority's transparency policy. However, not all details of the methodologies of the FME will be disclosed.

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[1] The criteria and methodologies described in this document are an addition to information that the FME has published pursuant to Art. 116(a) of Act No 161/2002 (in Icelandic): http://www.fme.is/um-fme/gagnsaei-i-eftirliti/

[2] Guidelines on common procedures and methodologies for the supervisory review and evaluation process (SREP) and supervisory stress testing (EBA/GL/2014/13 as amended by EBA/GL/2018/03): https://www.eba.europa.eu/documents/10180/2282666/Guidelines+on+common+procedures+and+methodologies+for+SREP+and+supervisory+stress+testing+-+Consolidated+version.pdf

[3] Annex 1: Supervisory benchmarks for the setting of Pillar 2 additional own funds requirements for credit and concentration risk.

[4] Annex 2: Supervisory benchmarks for the setting of Pillar 2 additional own funds requirements for market risk.

[5] Annex 3: Methods for setting capital buffers.

As an example, the complete list of variables for the categorisation of institutions will not be disclosed and neither will individual SREP scores, as such disclosure may 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.

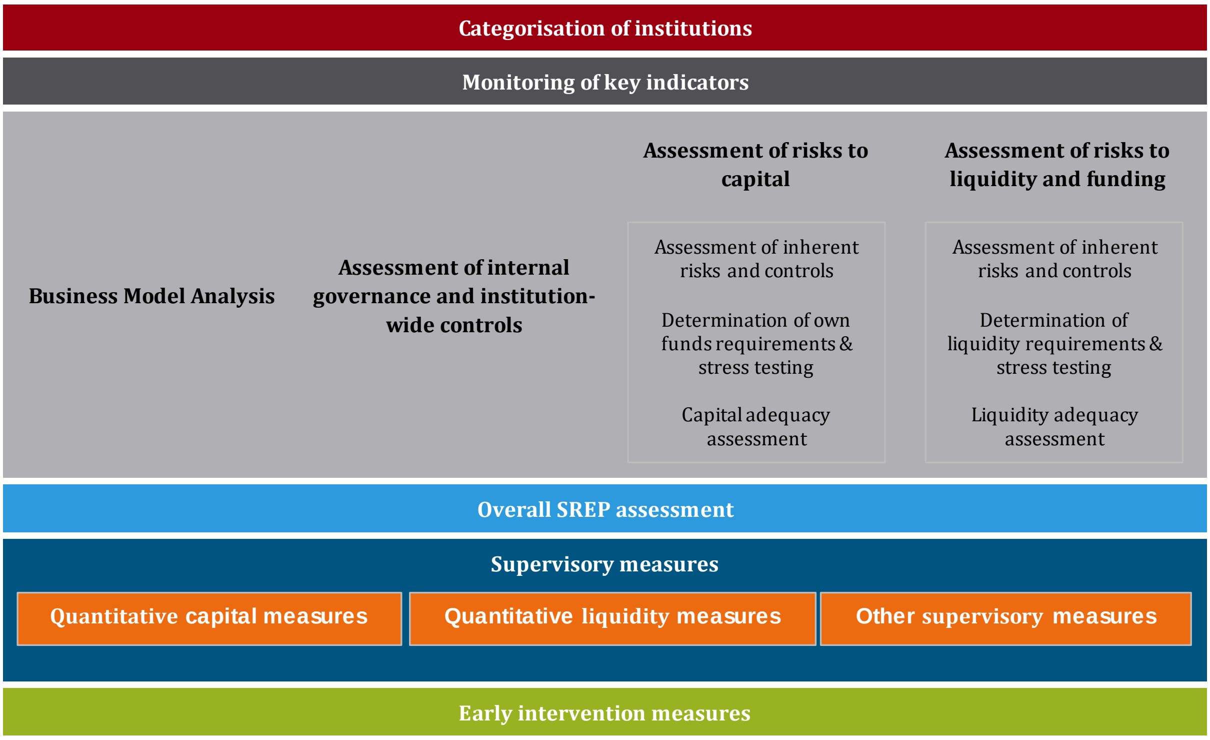

Figure 1: The SREP framework

2.2 Categorisation of institutions

The FME applies the principle of proportionality in its supervisory activities, that is, 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 FME. The values are collated from regularly reported data provided to the FME (*í. reglubundin gagnaskil*), inspections and other relevant information acquired by the FME.

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

Table 1: Impact categorisation of institutions

Impact Category of Institutions	Description
High impact	Institutions that can threaten financial stability when ailing or failing.
Medium-high impact	Institutions that do not threaten financial stability when ailing or failing, but can 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 can 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 FME 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 more frequent for institutions categorised as *high-impact* than for institutions in lower impact categories. Generally, the nature of inspections, and the time allotted to them, is determined by impact category and the nature of the institutions' activities.

2.3 Monitoring of key risk indicators

In addition to its observance of financial market developments, the FME monitors key risk indicators of relevant institutions no less than quarterly. Monitoring of key risk indicators is mainly based on regularly reported data and can indicate changes in risk or exposure in the activities of institutions, or indicate risks that need further enquiry. The FME regularly reviews the key risk indicators monitored. Key risk indicators of the FME are, among other things, based on the common risk indicators of the EBA.[6]

2.4 Assessment of risks

The FME 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 frequently if necessary.

[6] EBA risk indicators and detailed risk analysis tools: http://www.eba.europa.eu/risk-analysis-and-data/risk-indicators-guide

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

Assessment of individual risks is based on the inherent risk and the risk management systems that exist within the institution. The risk assessment is thus intended to assess the underlying risks in the activities of an institution, considering 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 on the scores).

2.4.1 Analysis of business models

The business model analysis aims to identify possible threats to the viability[7] of the business model and the sustainability[8] of the overall strategy of the institution. The business model and overall strategy are evaluated given the risk appetite of the institution and performance in recent years. Assumptions for the expected development of 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 FME. The data is 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 FME also uses stress testing to determine the impact of a baseline scenario on an institution's income statement and balance sheet and 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 institutions fulfil the requirements for proper governance and internal control, whether there are comprehensive management and control systems within the institution, and whether risk management and internal control is proportional to the risk appetite, business plan, nature, scope and activities of the institution. In this evaluation process, consideration is given to whether the governance and internal control generate risks and affect the viability of the institution.

The assessment covers governance, organisational structure, corporate and risk culture, background, experience and composition of the board of directors, the institution's remuneration policy, outsourcing, risk management, internal control, contingency planning and information technology systems. However, the assessment does not include risk management and internal control related to individual risks. The assessment is based on the ICAAP report of the institution, regularly reported data and other information, interviews with board members, directors and other employees of the institution, and information acquired from on-site inspections. In this

[7] Viability of the business model: Ability to generate sufficient returns over the short term (next 12 months).
[8] Sustainability of the overall strategy: Ability to generate sufficient returns over the long term (at least 3-year projection).

assessment, the FME uses EBA's Guidelines on internal governance of institutions[9] and other recognised guidelines on corporate governance.

2.4.3 Assessment of risks to capital

Risk assessment for critical risks that affect own funds of institutions 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, among other things, with regard to the estimated own funds requirements:

Credit, counterparty and concentration risk[10]

According to Art. 78(a) of Act No 161/2002, institutions should apply their own methodologies when assessing credit and counterparty risk from exposures from individual borrowers, securities, securitised exposures and their entire credit portfolios. Additionally, pursuant to Art. 78(c) of the same Act, institutions shall assess and manage concentration risk arising from individual counterparties within the same sector of the economy, in 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. Art. 78(b) of Act No 161/2002.

Credit risk is the risk of losses arising from a borrower failing to make required payments as they fall due. Counterparty risk refers to 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 and is divided into *single-name*, *sectoral* and *geographic risk.*

When assessing credit and counterparty risks, the FME focuses on inherent risk and risk management of the institution. Among other things, the FME 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 FME considers risk that results from a small number of exposures, or exposures that have similar characteristics with reference to defaults and how the institution manages said defaults. The assessment includes an analysis of the possible correlation of defaults, 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 FME regularly calls for data and information on own funds and other balance sheet items from institutions to assess credit risk, counterparty risk and concentration risk. The FME also acquires additional information that is utilised in the evaluation process, for example, to verify data and information acquired from the institutions.

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[9] Guidelines on internal governance (EBA/GL/2017/11):
https://www.eba.europa.eu/documents/10180/2164689/Guidelines+on+Internal+Governance+%28EBA-GL-2017-11%29_EN.pdf/531e7d72-d8ff-4a24-a69a-c7884fa3e476.

[10] See Annex 1: Supervisory benchmarks for the setting of Pillar 2 additional own funds requirements for credit and concentration risk.

Market risk[11]

According to Art. 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 FME assesses the inherent market risk of institutions and its management, both in the trading book and banking book. Additionally, the FME assesses the following risk sub-categories using its own criteria that, among other things, are based on sensitivity analysis and VaR analysis in accordance with the EBA Guidelines on Stressed Value at Risk:[12]

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

The FME regularly calls for data and information on own funds and other balance sheet items from institutions to assess market risk. The FME also acquires additional information that is utilised in the evaluation process, for example, to verify data and information received from the institutions.

Interest rate risk in the banking book (IRRBB)

According to Art. 78(g) of Act No 161/2002, relevant institutions shall analyse, assess and manage the risk of potential interest rate changes affecting its transactions outside the trading book.

Interest rate risk in the banking book or IRRBB refers to the 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 FME assesses the standard of an institution's management of IRRBB. The impact of sudden up and down parallel shifts of the relevant yield curves (applying a 0% floor) are assessed in accordance with the EBA Guidelines.[13] The impact of these shifts on the present value of interest-bearing assets and liabilities in each currency is the basis for the FME's risk assessment.

The FME regularly calls for data and information on own funds and other balance sheet items from institutions to assess IRRBB risk. The FME also acquires additional information that is utilised in the evaluation process, for example, to verify data and information received from the institutions.

Operational risk

Pursuant to Art. 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

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[11] See Annex 2: Supervisory benchmarks for the setting of Pillar 2 additional own funds requirements for market risk.
[12] Guidelines on stressed Value-at-Risk (Stressed VaR) (EBA/GL/2012/2): https://www.eba.europa.eu/documents/10180/104547/EBA-BS-2012-78--GL-on-Stressed-VaR-.pdf
[13] Guidelines on the management of interest rate arising from non-trading activities (EBA/GL/2015/08): https://www.eba.europa.eu/documents/10180/1084098/EBA-GL-2015-08+GL+on+the+management+of+interest+rate+risk+.pdf

from rare events that may have material effects. 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,
- legal and political risk,
- model risk,
- information technology risk, and
- reputational risk.

The FME assesses the inherent operational risk, centred on the sub-categories mentioned above and other risks that are considered of particular interest, and the management and control of these risks within the institution.

The FME regularly calls for data and information on own funds and other balance sheet items from institutions to assess operational risk. The FME also acquires additional information that is utilised in the evaluation process, for example, to verify data and information received from the institutions.

2.4.4 Assessment of risks to liquidity and funding

Institutions must continuously address their ability to monetise their liquid assets in a timely fashion in order to meet their deposit withdrawals and other payment obligations, cf. Art. 83 of Act No 161/2002.[14] Institutions are required to formulate and implement strategies, policies, documented procedures, methods and systems to analyse, assess and control liquidity and funding risk, cf. Art. 78(h) of the same Act.

The FME's assessment of an institution's liquidity and funding needs is an integral part of the SREP, cf. Par. 2 of Art. 79 and Par. 2 of Art. 81 of Act No 161/2002.[15] The assessment is based on three factors. Firstly, an assessment of liquidity and funding risks management. Secondly, an assessment of the inherent liquidity risk. And thirdly, an assessment of the inherent funding risk.

The assessment of liquidity and funding risk management includes evaluation of the liquidity strategy and whether the institutions operate under the 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 funding profile of the institution and its stability, evaluates potential threat to financial stability stemming from the funding profile, the

[14] See also Rules No 266/2017 on liquidity ratios of credit institutions and Rules No 1032/2014 on funding ratios in foreign currencies.

[15] The FME and the Central Bank of Iceland cooperate on the supervision of the liquidity risk of institutions, see here (in Icelandic): http://www.fme.is/media/um-fme/Samstarfssamningur.pdf

market access of the institution and the expected change in funding risks with reference to the institution's funding plan.

The FME's assessment of the above-mentioned factors is based, in particular, on FME Guidelines No 2/2010 on best practice of liquidity management,[16] ICAAP and ILAAP reports, regularly reported data, on-site inspections and other information that may be relevant to evaluate liquidity and funding risks and that are considered essential to complete the assessment.

The outcome of the assessment may lead to requirements for improved management and control of the risks or an increase of liquid assets.[17] The outcome may also lead to requirements of extending maturity, additional own funds, reduction of off-balance-sheet exposures etc.

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 FME engages in a dialogue with the institution and stipulates corrective actions for said institution. Supervisory measures may include own funds measures, liquidity measures and other supervisory measures. Corrective actions are considered administrative acts 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 FME uses the scores, among other things, to prioritise projects and engagement, and they are considered a part of the FME's risk-based supervisory architecture. However, they do not directly affect specific requirements for corrective actions (for instance, own funds requirements), and are not disclosed to individual institutions. The rating scale is from one to four (see Table 2).

[16] See in Icelandic: http://www.fme.is/log-og-tilmaeli/leidbeinandi-tilmaeli/nr/921

[17] According to an agreement between the FME and the Central Bank of Iceland (CBI) on supervision of liquidity of institutions, the FME proposes to the CBI special liquidity measures if necessary.

Table 2: Risk scores overview

SREP score	Description
1	Minimal risk identified.
2	The risk identified is limited, but performance can be improved. Critical to monitor possible weaknesses in the operations of the institution.
3	The risk identified poses medium-to-high levels of risk to 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 Art. 86(h) of Act No 162/2002 or measures pursuant to Ch. XII and Temporary Provision VI.

3. The FME capital requirements

3.1 General

The FME's decision on additional own funds requirements under Pillar II is two-fold:[18]

- Pillar II capital requirements (P2R) for risks, that is, the risk of expected losses and unexpected losses insufficiently covered by Pillar I,[19] over a 12-month period.
- Pillar II capital guidance (P2G) to meet stressed conditions, that is, possible risk of losses caused by adverse conditions over the economic cycle not covered sufficiently under Pillar I and Pillar II requirements, or relevant capital buffers.

[18] Pursuant to Par. 7 of Art. 86(g) of Act No 161/2002, the Pillar II capital maintained must be comprised of at least 56.25% CET1 capital and 75% Tier 1 capital.

[19] Pillar I is the minimum own funds requirement, that is, eligible own funds maintained at least 8% of total risk exposure amount, cf. Par. 1 of Art. 84 of Act No 161/2002. Pillar I eligible own funds shall be comprised of Tier 1 capital, cf. Art 84(a) and 84(b), Tier 2 capital, cf. Art 84(c), net of deductions, pursuant to Art. 85. Thereof, CET1 capital shall, net of deductions, be at least 4.5% of the total risk exposure amount and Tier 1 capital shall be, net of deductions, at least 6% of total risk exposure amount.

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

3.2.1 General

According to Par. 1 of Art. 84 of Act No 161/2002,[20] a relevant institution's own funds must be at least 8% of its total risk exposure amount.[21] 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. Par. 1 of Art. 80 of Act No 161/2002. The assessment is carried out internally and reported with an ICAAP report to the FME.

The FME evaluates risks relevant to the capital needs of institutions in accordance with Art. 79-81 of Act No 161/2002, cf. Art. 86(g) of the same Act. The FME's assessment rests mainly on data regularly reported to the FME, in particular ICAAP reports, financial statements and internal audit reports. Additionally, the FME gathers further information through dialogue with institutions and with specific inspections during the SREP.

The FME's evaluation reflects to what extent the measures taken by the institution are adequate, whether management is sound and whether own funds maintained are sufficient, given the level of risk entailed in the institution's activities. The conclusion of the FME may result in supervisory engagement where the FME can enforce the following supervisory measures under Par. 4 of Art. 86(g) of Act No 161/2002:

a. requiring own funds of more than 8% of 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 derived 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 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 pay-out will lead to insufficient own funds,
h. requiring net profits to be allocated to strengthen own funds,
i. limiting or prohibiting dividends and interest payments to shareholders and investors,
j. requiring increased data reporting, and
k. requiring ad hoc disclosure to the market.

In addition, the FME can comment and propose action in accordance with Par. 1 of Art. 10 of Act No 87/1998 on Official Supervision of Financial Activities.

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

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[20] See also Regulation No 233/2017 (in Icelandic): https://www.reglugerd.is/reglugerdir/eftir-raduneytum/fjarmala--og-efnahagsraduneyti/nr/20476

[21] 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. Art 84 (e) of Act No 161/2002.

a. ICAAP calculations,
b. outcome of supervisory benchmark calculations,[22] and
c. other relevant inputs, including those arising from interaction and dialogue with the institution.

In an effort to ensure the quality of the FME's evaluation of individual risks affecting own funds, the FME has developed risk-specific supervisory benchmarks for certain sub-categories of individual risks. However, the FME emphasises that institutions should develop and apply their own detailed criteria and methodologies for the evaluation of inherent risk. If the FME considers the institution's own criteria and methodologies sufficient and appropriate, the FME favours them proportionally to support the determination of own funds.[23] If, however, the FME considers the institution's own criteria and methodologies insufficient or inappropriate, the FME will favour its own supervisory benchmarks and judgement to support the determination of additional own funds. The FME's results are not meant to substitute the institution's own assessment of inherent risk rather the institution should urgently evaluate the risks of its activities in a sufficient manner.

In the FME'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 FME can 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 FME uses financial information at the end of the year. Although the decision on capital adequacy requirement is not made until at least half a year later, changes in the development of individual risks 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. 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 Par. 1 of Art. 84 of Act No 161/2002, and additional own funds requirements determined by the FME. The decision is made with reference to section (a) of Par. 4 of Art. 86(g) of Act No 161/2002 that states that the FME 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 FME's prescription.

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, the institutions shall operate so as to meet its expected capital needs during stressed conditions.

[22] For further information, see Annexes.

[23] *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 FME will, among other things, evaluate if the institution's methods can be considered detailed, credible, understandable and comparable.

The FME will assess the adequacy of the institution's own funds to cover possible volatility and shocks in stressed conditions. The assessment is grounded in the results of supervisory stress tests. Furthermore, the FME reviews the results from stress testing carried out by other supervisory bodies and the ICAAP stress test of the institution (own scenario).[24]

The FME'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 go below the capital conservation buffer, and under special circumstances, below the countercyclical capital buffer as well, the FME can 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 FME considers plans for credible management actions, intended to mitigate the impact on the institution's own funds. The FME assesses the CET1 ratio at 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 FME, additional supervisory measures may be considered, including increased supervision or additional capital requirement (Pillar II-R) under special circumstances.

3.4 Capital buffers

Pursuant to Art. 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 Art. 86(b)-(e) of the same Act:[25]

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

The FME is required to set capital buffers for all systemically important institutions, following the recommendations of the Financial Stability Council. Additionally, the FME is authorised to set O-SII buffers and countercyclical buffers for other institutions, following the recommendations of the Council. The capital conservation buffer is added to the capital requirement of specific institutions without the Council making recommendations and without the FME making a decision.[26]

[24] Guidelines on institutions' stress testing (EBA/GL/2018/04): https://www.eba.europa.eu/documents/10180/2282644/Guidelines+on+institutions+stress+testing+%28EBA-GL-2018-04%29.pdf
[25] Capital buffers can only be met with CET1 capital, pursuant to Art. 84(a) of Act No 161/2002, cf. Art 86(a) of the same Act.
[26] See Annex 3: Methods for setting capital buffers.

3.5 Overall capital requirement and supervisory measures for insufficient capital

If an institution does not meet the overall capital requirement, that is, the FME's minimum capital requirement in addition to the combined buffer requirement, cf. Art. 86(a) of Act No 161/2002, the allocation of profits, as well as bonus and dividend payments, is limited or restricted, cf. FME Rules No 1270/2015 on maximum outbound payments and limits to outbound payments by cause of capital buffers. Additionally, in these conditions, the board of directors of the relevant institution must submit to the FME documentation describing how the institution will conserve own funds, cf. Art. 86(f).

Par. 4 of Art. 86(b) 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 limits or restrictions of outbound payments, pursuant to Art. 86(a), Par. 6, are considered insufficient to strengthen own funds of the institution, the FME can enforce the following supervisory measures:

1. Revoke the institution's operating licence partially or in full pursuant to Art. 9, Par. 1, Point 10.
2. Require corrective actions pursuant to Art. 86(g), Par. 4.
3. Impose additional liquidity requirements, if the institution does not hold an operating licence pursuant to Art. 4, Par. 1, Points 1-3, cf. Art. 6.
4. Appeal to the Central Bank of Iceland, in cases where the institution does hold an operating licence pursuant to Art. 4, Par. 1, Points 1-3, cf. Art. 6., to impose additional liquidity requirements.

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

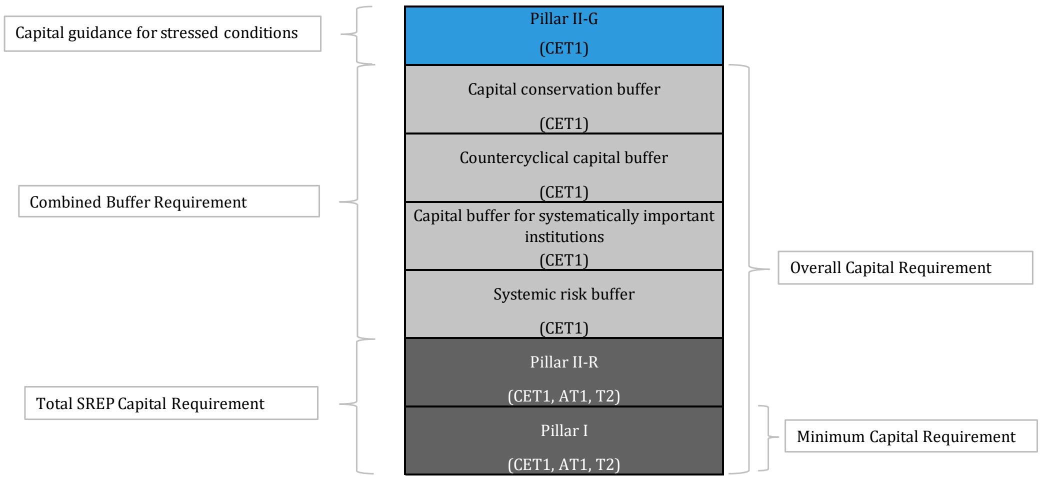

Figure 2: Stacking order of own funds requirements

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

The FME informs an institution on the results of the SREP 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 FME's decision on the Total SREP Capital Requirement (TSCR) and is broken down in the following risks:

a. credit, counterparty and concentration risk,
b. market risk and IRRBB, and
c. other risks, that is, operational risk, risk from subsidiaries etc.

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

The FME publishes on its website, via a transparency announcement,[27] a summary of the main results of the SREP, including the Total SREP Capital Requirement and the Overall Capital Requirement (OCR).

[27] Cf. Art. 9(a) of Act No 87/1998 and the FME's transparency policy (in Icelandic): https://www.fme.is/media/um-fme/Gagnsaeisstefna-FME-16.4.2014.pdf.