# Chapter Nineteen –
# Supervisory Review and Evaluation Process (SREP) in the Context of the Exercise of Supervisory Powers and Extraordinary Measures

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## 18.1 SREP: Legal Basis and Interaction with Pillar 2 Capital Requirements

The concepts of Pillar 2 and Supervisory Review and Evaluation Process (SREP) were adopted by Basel II[1] to promote a better measurement and management by credit institutions of their risks and to make capital requirements more risk-sensitive and more individually tailored than under previous Basel Committee on Banking and Supervision (BCBS) standards. The idea was certainly not new, and a number of jurisdictions had already in place at the time some forms of supervisory dialogue and non-binding, individual target capital ratios.[2] Basel II provided however a comprehensive global standard, based on the assumption that Pillar 1 capital requirements needed individual adjustments based on both self-assessment and supervisory review of the institution's risk profile. This revolves around four principles, addressed respectively to institutions (1) and supervisors (3):[3] (a) banks have to assess on their own and to demonstrate their capital adequacy and therefore own funds' consistency with the overall risk profile and this must be done by developing an Internal Capital Adequacy Assessment Process (ICAAP), i.e. a self-assessment meant to measure all material risks to which the bank is exposed through a monitoring and reporting system including also internal forward-looking stress tests; (b) supervisors should regularly evaluate the soundness of the ICAAP through a SREP; (c) supervisors should expect banks to operate above Pillar 1 minimum requirements and should have the power to require capital in excess of such minimum requirements and/or to promote higher targets; (d) supervisors should intervene at an early stage to prevent capital from falling below the minimum levels required, adopting a wide set of measures ranging from restricting distributions, to requiring a capital restoration plan or additional capital.

The Capital Requirements Directive (CRD) of 2006[4] implemented Basel II, regulating both ICAAP and SREP in quite general terms[5]. As to SREP, Article 124 provided, in turn, that:

> 1. "Taking into account the technical criteria set out in Annex XI, the competent authorities shall review the arrangements, strategies, processes and mechanisms implemented by the credit institutions to comply with this Directive and evaluate the risks to which the credit institutions are or might be exposed.

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[1] Basel Committee on Banking Supervision (BCBS), 'International Convergence of Capital Measurement and Capital Standards: A Revised Framework', first adopted in 2004 and supplemented with the Application to Basel II to Trading Activities and the Treatment of Double Default Effects of 2005 to establish the comprehensive version published in June 2006 (hereinafter: Basel II).

[2] Compare Marco Bevilacqua and others, 'The evolution of the Pillar 2 framework for banks: some thoughts after the financial crisis' (2019) 494 Questioni di Economia e Finanza (Occasional Papers) 1, 5.

[3] Bevilacqua, *op.cit*, 6-8.

[4] Directive (EC) 2006/48 relating to the taking up and pursuit of the business of credit institutions [2006] OJ L177/1 (hereinafter: CRD).

[5] On ICAAP, CRD Art 123provided that 'credit institutions 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'.

2. The scope of the review and evaluation referred to in paragraph 1 shall be that of the requirements of this Directive.
3. On the basis of the review and evaluation referred to in paragraph 1, the competent authorities shall determine whether the arrangements, strategies, processes and mechanisms implemented by the credit institutions and the own funds held by these ensure a sound management and coverage of their risks.
4. Competent authorities shall establish the frequency and intensity of the review and evaluation referred to in paragraph 1 having regard to the size, systemic importance, nature, scale and complexity of the activities of the credit institution concerned and taking into account the principle of proportionality. The review and evaluation shall be updated at least on an annual basis.
5. The review and evaluation performed by competent authorities shall include the exposure of credit institutions to the interest rate risk arising from non-trading activities. Measures shall be required in the case of institutions whose economic value declines by more than 20 % of their own funds as a result of a sudden and unexpected change in interest rates the size of which shall be prescribed by the competent authorities and shall not differ between credit institutions."

Annex XI CRD set out the technical criteria to be applied in the SREP, which at the time were as follows:

> "In addition to credit, market and operational risks, the review and evaluation performed by competent authorities pursuant to Article 124 shall include the following:
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> a) the results of the stress test carried out by the credit institutions applying an IRB approach;
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> b) the exposure to and management of concentration risk by the credit institutions, including their compliance with the requirements laid down in Articles 108 to 118;
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> c) the robustness, suitability and manner of application of the policies and procedures implemented by credit institutions for the management of the residual risk associated with the use of recognized credit risk mitigation techniques;
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> d) the extent to which the own funds held by a credit institution in respect of assets which it has securitised are adequate having regard to the economic substance of the transaction, including the degree of risk transfer achieved;
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> e) the exposure to and management of liquidity risk by the credit institutions;
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> f) the impact of diversification effects and how such effects are factored into the risk measurement system; and
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> g) the results of stress tests carried out by institutions using an internal model to calculate market risk capital requirements under Annex V to Directive 2006/49/EC."

CRD IV[6] repealed Directive 2006/48 and regulated SREP, still in quite general terms, in Articles 97 and 98. Article 97 sets out the scope of the review and evaluation, which is aimed at determining whether the arrangements, strategies, processes and mechanisms implemented by institutions and the own funds and liquidity held by them ensure a sound management and coverage of the risks they are

[6] Directive (EU) 2013/36 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC [2013] OJ L 176/338 (hereinafter: CRD IV). CRD IV was modified by the Banking Package Directives, notably Directive (EU) 2019/878 amending Directive 2013/36/EU (CRD V) [2019] OJ L 150/253 as regards exempted entities, financial holding companies, mixed financial holding companies, remuneration, supervisory measures and powers and capital conservation measures as regards exempted entities, financial holding companies, mixed financial holding companies, remuneration, supervisory measures and powers and capital conservation measures. This has led to the fifth iteration of the capital requirements framework.

exposed to, the risks they pose to the system, and those revealed in stress testing exercises.[7] The SREP frequency and intensity must be calibrated according to the principle of proportionality and updated at least annually for institutions that (a) are systemically relevant, (b) have shown fragilities in their risk profile in previous reviews, or (c) for which such a review is deemed appropriate by the competent authority.

Article 98 CRD IV, in turn, replaces Annex XI of Directive 2006/48, and lists SREP's technical criteria, including stress tests results, exposure to and management of concentration risk, suitability of procedures to deal with residual risk associated with the use of credit risk mitigation techniques, adequacy of capital in light of the risk of securitized assets, in light of the transaction's economic substance and degree of risk transfer, liquidity risk management, including alternative scenario analyses, risk mitigants and contingency plans, the impact of diversification effects, or the institution's exposures' geographical location and its business model and assessment of systemic risk. The SREP also includes the institution's governance arrangements, corporate culture and values, and its management body members' ability to perform their duties. Thus, authorities shall have access to agendas and supporting documents for meetings of management bodies and their committees, and to results of internal/external evaluation of the management body's performance.

Talking about SREP using the language of 'Pillar 2 capital' can be deceptively simple, though, especially in the European context, where both the framework and its implementation shows the tension between the need for consistency and diversity, which result in a 'relational' supervision with a depth and intensity that constitute the framework's distinctive feature. Starting with 'consistency', the need to harmonize the process across jurisdictions and authorities explains Article 107 CRD IV, which sets up a framework that includes competent authorities' duty to report to EBA, and EBA's organization of peer review exercises[8] and elaboration of guidelines,[9] the first adopted in 2014 and amended in 2018[10] provide 'a common framework for the work of supervisors in their assessment of risks to banks' business models', their solvency and liquidity as well as the conduct of supervisory stress testing and do represent 'a major step forward in forging a consistent supervisory culture across the single market'.

At the same time, the CRD IV framework tries to take into consideration the diversity of banking models and risks present in the European Union. In the Basel Framework all additional capital in excess of Pillar 1 requirements is treated as a mere supervisory expectation in the form of trigger/target ratios.[11] In the European setting, the capital add-on to be held in excess of Pillar 1 is a response to the individual prudential evaluation of *each institution* with two components, one binding and one non-binding. The first component, the 'Pillar 2 Requirement' (P2R) is binding, and thus must

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[7] CRD IV, Art 97 provides that 'taking into account the technical criteria set out in Art 98, the competent authorities shall review the arrangements, strategies, processes and mechanisms implemented by the institutions to comply with this Directive and Regulation (EU) No 575/2013 and evaluate: (a) risks to which the institutions are or might be exposed; (b) risks that an institution poses to the financial system taking into account the identification and measurement of systemic risk under Art 23 of Regulation (EU) No 1093/2010, or recommendations of the European Systemic Risk Board (ESRB), where appropriate; and (c) risks revealed by stress testing taking into account the nature, scale and complexity of an institution's activities'.

[8] Under Art 30 of Regulation (EU) establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC [2010] OJ L 331 (hereinafter: EBA Regulation).

[9] Under Art 16 of EBA Regulation, to 'specify, in a manner that is appropriate to the size, the structure and the internal organization of institutions and the nature, scope and complexity of their activities, the common procedures and methodologies for the supervisory review and evaluation process'.

[10] EBA, 'Guidelines on the revised common procedures and methodologies for the supervisory review and evaluation process (SREP) and supervisory stress testing' (19 July 2018) (hereinafter: EBA, 'SREP Guidelines') <www.https://eba.europa.eu/sites/default/documents/files/documents/10180/2282666/fb883094-3a8a-49d9-a3db-1d39884e2659/Guidelines%20on%20common%20procedures%20and%20methodologies%20for%20SREP%20and%20supervisory%20stress%20testing%20-%20Consolidated%20version.pdf> accessed 13 September 2020.

[11] Bevilacqua, *op.cit.*, 9.

be met at all times.[12] For its determination the EBA Guidelines point at the need for the competent authority to *assess* and translate into an additional capital requirement three major risks: (a) unexpected losses and expected losses insufficiently covered by provisions over a 12-months period; (b) underestimated potential IRM failures; (c) governance failures. The second component is the 'Pillar 2 Guidance' (P2G),[13] which is defined by the EBA Guidelines as 'a non-legally binding capital expectation at level over and above overall capital requirements based on the SREP findings, in particular (a) the ability to meet the applicable own funds requirements in stressed conditions or (b) supervisory concerns over the (excessive) sensitivity of an institution towards scenarios assumed in supervisory stress testing'. P2G is thus *above* the level of binding capital (minimum and additional) *and* the combined buffers. Unlike the first component, P2R, if the bank does not meet its P2G, this neither results in automatic action by the supervisor nor triggers restrictions on distributions. Rather, it should be used to fine-tune measures based on the bank's individual situation, and the supervisor must be timely informed that the target is not met and will the situation on a case-by-case basis.[14]

This introduces a qualitative approach within the supervisory task, which crucially deepens the relationship between the supervisor and the supervised and increases its intensity. In essence, Pillar 2 capital should address risks not covered or insufficiently covered by Pillar 1, without overlapping with it, or be used as a contingent measure to temporarily address institution-specific deficiencies that are not fully remedied by that institution. Thus, it is a supervisory response which must be reactive enough, either raising or lowering the supervisory requests depending on the circumstances,[15] to adapt in a timely, proportionate and non-discriminatory way to the individual risks and determine the bank's actions to tackle them. This means that a supervisor can no longer choose to mechanistically rely on quantitative metrics. Reliance on stress testing is, to a certain extent, inevitable, since SREP should adopt a forward-looking perspective for risks, which is beyond the ordinary supervisory models in the so-called Risk Assessment System in the Single Supervisory Mechanism (SSM) taxonomy, and the stress-testing methodologies in the ICAAP. Yet, since stress testing models 'are by construction a simplified representation of what could happen in the near future' and are exposed to 'a high degree of uncertainty',[16] Pillar 2 should also rely on supervisory judgment of such results, rather mechanically transposing them into P2G.[17] Furthermore, this requires a more 'relational' supervisory approach because the SREP entails an assessment of areas, such as corporate governance, culture and values, or management, which requires a level of interaction that transcends quantitative measures, and requires qualitative, critical analysis and judgment calls.

Pillar 2 binding and non-binding requirements were originally covered by Common Equity Tier 1 (CET1) instruments only. The EBA also requires that P2G own funds are not 'used twice', i.e. they cannot be used to meet any other regulatory requirements (e.g. to cover P2G *and* a potential shortfall in Additional Tier 1 (AT1) or Tier 2 (T2) instruments). However, the applicable legal framework

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[12] Otherwise, supervisory and other extraordinary measures, up to the withdrawal of the license under Art 18 CRD or an assessment of failing or likely to fail under Art 32 BRRD may be adopted.

[13] Fully implemented for **SIs** and which needs to be implemented (by NCAs) for LSIs by 2021. ECB 'SSM LSI SREP Methodology' [2020] (hereinafter: ECB, 'SSM LSI SREP Methodology'), 18 < https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.srep_methodology_booklet_lsi_2020.en.pdf > accessed 13 September 2020.

[14] ECB, SSM SREP Methodology Booklet, 2018 edition to be applied in 2019. Level playing field – High standards of supervision – Sound risk assessment (2018) 27 (hereinafter: ECB 'SSM LSI SREP Methodology 2018') <https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.srep_methodology_booklet_2018~b0e30ced94.en.pdf> accessed 13 September 2020. However, as seen below, P2G is hardly a measure that banks can afford to dismiss, and repeated failures to meet the 'soft' P2G can constitute the basis for supervisory measures, in the form of a 'hard' additional capital requirement.

[15] ECB, 'SSM SREP Methodology 2018', 16. Adjustments can go in both directions and are fully documented by the JST in the integrated IT system.

[16] Bevilacqua, *op.cit.*, 24.

[17] Bevilacqua, *op.cit.*, 28-29.

allows now for some flexibility in terms of capital instruments. CRD V expressly states that supervisory authorities will have the power to require that P2R must be met solely with CET1 capital *where necessary* and having regard to the specific circumstances of the institution.[18]

CRD V further introduced a number of changes to Pillar 2, to better clarify, first, with new Article 104a that additional capital requirements must be set by decomposing each component of the Pillar 2 capital add-on 'on the basis of the underling risk drivers' (in the words of the EBA Guidelines) and, second, with new Article 104b, that add-ons may be justified also by the need, assessed by the competent authority, to absorb potential losses resulting from stress tests, including those performed by the supervisors. The amendments further clarifies that P2R can be used to address systemic-wide risks only to the extent that they could credibly morph into a measurable risk on an individual basis (and thus not as a macroprudential tool).[19]

As a final consideration, the SREP's relational supervisory model helps to bridge the gap between supervisory and crisis-management situations. Should the SREP show that the institution does not meet the prudential requirements or is likely to breach the same within the following 12 months, Article 102 CRD V provides that competent authorities must require[20] an institution to take the necessary measures at an early stage to address relevant problems. This includes relying on a wide set of supervisory powers listed in Article 104 CRD V (discussed in detail in Paragraphs 18.3.1. and 18.4. of this chapter), which include at least the following: (a) to require institutions to hold own funds in excess of the Pillar 1 requirements; (b) to require the reinforcement of the governance arrangements, processes, mechanisms and strategies implemented in accordance with Articles 73 and 74; (c) to require institutions to present a plan to restore compliance with supervisory requirements pursuant to CRD V and to CRR and set a deadline for its implementation, including improvements to that plan regarding scope and deadline; (d) to require institutions to apply a specific provisioning policy or treatment of assets in terms of own funds requirements; (e) to restrict or limit the business, operations or network of institutions or to request the divestment of activities that pose excessive risks to the soundness of an institution; (f) to require the reduction of the risk inherent in the activities, products and systems of institutions; (g) to require institutions to limit variable remuneration as a percentage of net revenues where it is inconsistent with the maintenance of a sound capital base; (h) to require institutions to use net profits to strengthen own funds; (i) to restrict or prohibit distributions or interest payments by an institution to shareholders, members or holders of AT1 instruments where the prohibition does not constitute an event of default of the institution; (j) to impose additional or more frequent reporting requirements, including reporting on capital and liquidity positions; (k) to impose specific liquidity requirements, including restrictions on maturity mismatches between assets and liabilities; (l) to require additional disclosures. The EBA Guidelines extensively detail the use of these supervisory powers, giving a number of examples for each of the SREP element and, as to capital adequacy, for each of the risks to capital. They also clarify that in addition to such supervisory powers, the competent authorities may also adopt measures provided for under national law and, when applicable, early intervention measures as specified in Article 27 BRRD[21] or any combination of the above.

[18] Art 104a(4) of CRD V.
[19] For a comparison with the Pillar 2 framework adopted in the UK and US, compare Bevilacqua, *op.cit.*, 16-18.
[20] Having due care in treating in a 'similar or identical manner' institutions with similar risk profiles (Art 103 CRD V).
[21] Directive 2014/59/EU on the recovery and resolution of credit institutions and investment firms [2014] OJ L173 (herinafter: BRRD).

### 18.2 SSM SREP methodology and its outcomes in terms of capital

The framework for the exercise of the SREP is formed by CRD provisions discussed in Paragraph 18.1., as well as by the EBA Guidelines and Opinion.[22] Within the SSM, SREP is conducted for significant institutions by the Joint Supervisory Teams (JST) in accordance with the SSM Supervisory Manual first published in 2016 and updated annually, following a methodology for significant institutions.[23] For less significant institutions this is done, under Article 110 CRD V and in conformity with Articles 4 and 6 of the SSM Regulation, following the less significant institutions (LSI) SREP Methodology, which was developed by the European Central Bank (ECB) together with national competent authorities (NCAs), based on the EBA SREP Guidelines and building on the relevant parts of the SSM Supervisory Manual and national SREP methodologies in place. It was first implemented for high-priority LSIs, and then to no high-priority LSIs. The roll-out of the methodology to all LSIs is expected by the end of 2020.[24]

Since the SREP is an ongoing process, and for most institutions recurs on an annual basis, the methodology will continue to evolve in the future. Although the two methodologies are widely converging, the approach to LSI is designed to respond to the principle of proportionality. The intensity of the SREP assessment (in terms of frequency, scope and granularity), the supervisor's expectations and information needs depend on the classification of LSI as high-priority or non-high-priority institution. For the latter, the full SREP assessment is not performed annually, information reporting is significantly reduced in terms of scope and supervisory expectations are less demanding in terms of risk management methodologies and processes.[25]

In line with the EBA Guidelines, the SSM SREP follows a so called 'holistic approach' based upon four pillars: (a) business model assessment, (b) governance and risk management assessment, (c) risks to capital assessment and (d) risks to liquidity and funding assessment.[26] These elements help the SREP provide a synthetic overview of an institution's risk profile, taking also into account the institution's capital and liquidity planning, peer comparisons and the macro environment under which the institution operates.[27] Based upon the findings of the SREP, the SREP decision may include (a) quantitative capital measures either in the form of P2R, P2G or both, on top of Pillar 1 minimum own funds requirements and the combined buffer requirement, (b) institution-specific quantitative liquidity measures (LCR higher than the regulatory minimum, higher survival periods, national measures) and (c) other qualitative supervisory measures (stemming from Article 16(2) SSM Regulation). A major recent development has been the decision to disclose P2R, to enhance the role of market discipline, despite the negative market responses which may be triggered by such disclosures for weak banks, making it, in principle, harder to access capital markets to remedy any capital shortfall.

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[22] EBA, 'Opinion of the European Banking Authority (EBA) on the interaction of Pillar 1, Pillar 2 and combined buffer requirements and restrictions on distributions' (16 December 2015) (hereinafter: EBA 'Opinion on Interaction of Pillar 1 and 2'), <https://eba.europa.eu/sites/default/documents/files/documents/10180/983359/3f0814a6-342b-4679-8a65-fa1b51be1643/EBA-Op-2015-24%20Opinion%20on%20MDA.pdf?retry=1> accessed 13 September 2020.

[23] ECB, 'SSM LSI SREP Methodology 2018'.

[24] ECB 'SSM LSI SREP Methodology', 2. Nonetheless, the need to apply bank regulation in a proportionate manner, and/or to use "proportionality" as a principle in bank regulation has been constant subject of discussion at both an academic and practical (supervisory) level. See, e.g. Bart Joosen, Marco Lamandini, Matthias Lehmann, Kitty Lieverse, Ignacio Tirado Stability, Flexibility and Proportionality: Towards a two-tiered European Banking Law? *EBI Working Paper Series* 2018 no. 20. At supervisory level, proportionality was firmly advocated in the *Proportionality in Bank Regulation* A Report by the EBA Banking Stakeholder Group, 2014. In the SREP's specific context, proportionality was incorporated in the EBA SREP Guidelines 2014, Section 2.4. para. 36 p. 27.

[25] ECB, 'SSM LSI SREP Methodology 2018', 10.

[26] Since all these factors are to some extent interconnected, the overall assessment must comprehensively consider all of them, although the SSM is also strengthening a risk-by-risk methodology to better substantiate each measure against the specific risk justifying it.

[27] ECB, 'SSM LSI SREP Methodology 2018', 17.

Aggregate data concerning past SREP outcomes show that overall Pillar 2 demands are on the rise[28] and, as to capital measures, CET1 demands increase consistently with worse SREP scores. However, on aggregate, most significant institution have capital levels above Pillar 1 requirements and combined buffers.[29] As to the other measures communicated via SREP decisions, the 2018 SREP exercise identified 45 banks with liquidity-related measures and 83 banks with other qualitative measures.[30] This indicates a quite extensive use of such supervisory measures, on top of additional and various supervisory actions such as operational acts or follow-up letters.[31]

The common framework for the performance of the SREP assessment entails that, for each of its four elements (business model, governance and risk management, risks to capital, risks to liquidity and funding) the supervisor focuses on a quantitative perspective, based on establishing the 'risk level' (RL) and/or a qualitative perspective, based on 'risk controls' (RC), e.g. for the business model the focus is primarily quantitative, based on establishing the RL, for governance and risk management the focus is on RC, and for the assessment of capital and liquidity risks, there is both a quantitative RL and qualitative RC approach.[32] This quantitative/qualitative analysis of each of the elements is, in turn, completed in three phases: (a) Data gathering, (b) Scoring, and (c) Assessment.[33] The intensity of the supervisory engagement is decided based on bank's profile and size,[34] but in essence the data gathering exercise is followed by a process of scoring and analysing risk control procedures. Once this process is finished, the supervisor enjoys a margin of appreciation in the final say, although within some constraints. Phase 2 (Scoring) results in a four-grade "automated" scale, which is not definitive, because a Phase 3 (Assessment) is the supervisor's final say, where it can alter the automated score. Yet, that margin is not unlimited: scores can be improved by one notch or worsened by two notches based on supervisory judgment, to take into account the specificities and complexities of the specific institution (i.e. a bank cannot be moved from 1-to-4 or vice-versa).[35]

In practice,[36] the application of the three-stage methodology to the first element (business model) results in the Business Model Assessment (BMA), which is formed by (a) an identification of material business areas, mainly based on information provided by the institution, (b) a determination of Key Risk Indicators (KRI); and (c) a supervisory assessment, which includes a short-term assessment of the business model's viability, and a medium- and long-term assessment of the model's sustainability (leading to an adjustment +2/-1 notches of the results from the KRI stage). For the second element (governance and risk management), there is, again, (a) the information-gathering stage, based on the information provided by the institution itself; (b) a more mechanical process to checking compliance with CRD articles related to governance and risk management; followed by (c) a more specific

[28] ECB, 'The Supervisory Review and Evaluation Process. Overall SREP 2019 key messages' (2019), (ECB, 'The Supervisory Review and Evaluation Process') <https://www.bankingsupervision.europa.eu/banking/srep/srep_2019/html/aggregate_results_2019.en.html#toc1> accessed 13 September 2020.
[29] ECB, 'SSM LSI SREP Methodology 2018', 10.
[30] The exercise identified 42 banks with only qualitative liquidity SREP requirements, which were diverse and relating to a broad area of topics within liquidity risk management e.g. improvement of the ILAAP, including the stress test framework, the funding plan, intraday liquidity, one bank with both qualitative and quantitative liquidity SREP requirements (e.g. FX-denominated liquidity buffers) and 2 banks with only quantitative liquidity SREP requirements. As per the "other" measures, qualitative measures are applied for most banks scored 4 in SREP 2018, while other supervisory actions were implemented for the remaining banks. They covered a wide range of weaknesses (regarding Internal Governance and Risk Management (including ICAAP and ILAAP), NPL, IT and data quality). ECB, 'SSM LSI SREP Methodology 2018', 6.
[31] ECB, 'SSM LSI SREP Methodology 2018', 7.
[32] ECB, 'SSM LSI SREP Methodology 2018', 4.1.
[33] ECB, 'SSM LSI SREP Methodology 2018'.
[34] ECB, 'SSM LSI SREP Methodology 2018', 15.
[35] ECB, 'SSM LSI SREP Methodology 2018', 16. This is part of the so-called 'constrained judgment' principle, which tries to balance the supervisory judgment that takes into account the particularities of an institution, with the need for a common, consistent process. Thus, although supervisory judgment is present in all assessments, the common SREP methodology provides some anchor points, and the supervisory authority can only depart from them to a certain extent, plus it is obliged to document and justify each step, to enhance accountability.
[36] See ECB, 'The Supervisory Review and Evaluation Process', 4-7.

supervisory assessment of internal governance (including management body, organizational structure, audit, risk management and compliance functions or outsourcing), risk appetite and culture and remuneration, and risk infrastructure, data aggregation and reporting, which tries to assess whether the governance and risk frameworks work *in practice*.

An important element to understand the process is the relationship between the strategies and processes undertaken internally by the institution (ICAAP/ILAAP)[37] and the assessment by the supervisory authority via the SREP. This feedback loop is integrated into the supervisory process through the third and fourth SREP elements, i.e. 'risks to capital' and 'risks to liquidity'. In each of these two elements the determination of the capital and liquidity adequacy is based on several building blocks: Block 1 is a determination of 'risks to capital' and 'risks to liquidity', but Block 2 consists in challenging an institution's own assessment of its capital or liquidity needs, and Block 3 in challenging an institution's internal estimates of capital and liquidity needs under *stressed conditions*, which are undertaken in the institution's ICAAP[38] and ILAAP.[39] The goal is to assess whether the institution's ICAAP/ILAAP are *reliable*, whether they are embedded into their daily management process, including their impact in governance, etc, and can result into additional supervisory measures.[40] The addition of a review of the internal estimates under stress conditions ensures that a forward-looking perspective is incorporated into the analysis.

A further synergy exists with recovery plans, whose assessment feeds into the SREP assessment of internal governance and controls, as well as on their BMA (i.e. back to the first two elements of the SREP), while SREP assessments in turn feed into the assessment of recovery plans.[41] This helps to ensure that recovery planning is embedded into the overall institution's risk management framework.[42]

By way of summary, the 'dialogue' between an institution's self-assessment (through ICAAP/ILAAP and recovery plans), and the authorities' external assessment (under SREP, or the assessment of recovery plans), both informed by the forward-looking perspective of stress tests is hardwired into the structure of the SREP.

Finally, banks receive the outcome in a formal ECB SREP decision, which, rather than finishing the process, opens a series of avenues, because the results of the SREP constitute the basis for other actions. First, the SREP outcome can result in a wide range of measures that the institution needs to adopt to address capital and liquidity, as well as qualitative shortcomings. Second, they shape the upcoming supervisory cycle by informing the Supervisory Examination Programme (SEP),[43] and crucially determine the frequency and depth of the bank's supervisory activities. Thus, the SREP constitutes the main tool to calibrate the intensity of the supervisory authority's relationship with the bank, leading to recommendations that range from the deferential to the intrusive, and encompass the quantitative (e.g. capital and liquidity measures) but also the qualitative, e.g. the corporate governance

[37] ILAAP is an abbreviation for Internal Liquidity Adequacy Process.
[38] ECB, 'Guide to the internal capital adequacy assessment process (ICAAP)' (November 2018), (stress testing is contemplated under Principle 7) <https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.icaap_guide_201811.en.pdf> accessed 13 September 2020.
[39] ibid.
[40] See Paragraph 18.3.
[41] EBA 'SREP Guidelines', 15.
[42] ibid. Although ICAAP/ILAAP 'stress testing' and recovery plans' 'scenario testing' have different objectives, the methodologies and models are often the same. If the identification of 'severe, but plausible' scenarios for ICAAP/ILAAP stress testing meet certain requirements of severity and choice of scenarios, they can be used as one element in the scenario testing in recovery planning. Competent authorities, for their part, should use the (SREP) outcomes of institutions' stress testing to help their assessment of scenario testing in recovery plans.
[43] The SEP is drafted by the JST and consists of a series of strategic and operational planning for the upcoming supervisory cycle. See ECB, 'SSM LSI SREP Methodology 2018', 11.

and risk management of the institution. Thus, through its scoring + assessment + recommendations + iteration (for next cycle) the SREP helps to delineate the steps between a more rigid view of supervision as a data gathering exercise, and the dynamic setting of crisis-management. The framework of powers associated with the 'twilight area' of early intervention is firmly anchored on the supervisory powers that try to address SREP deficiencies, and it is the 'P' of SREP, and its incremental and iterative nature that gives legitimacy to the exercise of those powers.

### 18.3 Supervisory powers and other extraordinary measures based on the SREP findings

Although the SREP is an explicit (legal) acknowledgement of a 'relational' supervisory framework, such relational model ultimately relies on the assumption that the SREP has 'teeth', which means that, if a bank is non-compliant, the authorities have at their disposal a sufficiently broad arsenal of tools to redress the situation. Thus, supervisory powers' importance is not based on the frequency with which they are used, but on their availability. At the same time, being intrusive or very intrusive measures, they raise the greatest concerns of legality, due to their interference with rights such as property, freedom to conduct a business, good administration, or judicial protection. Thus, checking the clarity and consistency of the framework for the deployment of such measures is of fundamental importance. The legal issues concerning the exercise supervisory powers under the EU framework include (a) the dispersion of legal sources that contemplate such powers, which, predictably, create problems of interpretation and consistency, comprising but not limited to their relationship to (b) macroprudential measures and (c) 'soft' and preventive measures. The relationship with early intervention and bank resolution is discussed separately under Paragraph 18.4.

#### *18.3.1 Supervisory powers' multiple sources*

On the basis of deficiencies identified during the assessments of the individual SREP elements and taking into account the overall SREP assessment, supervisory authorities may deploy the 'Pillar 2 measures' contemplated under Articles 104, 104a and 105 CRD V. This 'twilight' area can quickly fade into black, and the authorities' powers need to switch to crisis-management gear, which encompasses early intervention measures under Article 27 of BRRD II,[44] alone or combined with the 'pure' supervisory measures. As the most drastic step following the SREP assessment, supervisory authorities may also withdraw the authorization of an institution that no longer meets its Pillar 1 or Pillar 2 capital requirements, or declare an institution 'failing or likely to fail' (FOLTF) under Article 32(1) BRRD II, if it breaches or may in the near future breach the requirements for continuing authorization in a way that justifies the withdrawal.[45] Even if linked, as a rule, to the SREP assessment, these decisions may directly follow, in some cases, the outcomes of any supervisory activities, where there is urgent need for their immediate application to address material deficiencies, irrespective of any previous adjustment of the current SREP assessment. These CRD V and BRRD II provisions have been interpreted by EBA's guidelines on: (a) early intervention triggers to adopt Article 27(4) BRRD measures[46]; or (b) the interpretation of FOLTF under Article 32(6) of the same directive.[47]

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[44] Directive (EU) 2019/879 amending Directive 2014/59/EU as regards the loss-absorbing and recapitalisation capacity of credit institutions and investment firms and Directive 98/26/EC [2019] OJ L 150/296 (hereinafter: BRRD II).

[45] Moreover, according to EBA, '[a]rticle 78 CRR provides that competent authorities shall grant permission for the reduction, repurchase or redemption of own funds only when the institution holds funds in excess of its Pillar 1 capital requirements, its combined buffer requirement, and the Pillar 2 capital requirement assessed on the basis of Article 104(3) of the CRD'. See EBA, 'Opinion on Interaction of Pillar 1 and 2' *op.cit.*.

[46] EBA, 'Guidelines on triggers for use of early intervention measures pursuant to Article 27(4) of Directive 2014/59/EU', (29 July 2015) <https://eba.europa.eu/sites/default/documents/files/documents/10180/1151520/9d796302-bbea-4869-bd2c-642d3d817966/EBA-GL-2015-03_EN%20Guidelines%20on%20early%20intervention%20measures.pdf?retry=1> accessed 13 September 2020.

[47] EBA, 'Guidelines on the interpretation of the different circumstances when an institution shall be considered as failing or likely to fail under Article 32(6) of Directive 2014/59/EU6' (August 2015) <https://eba.europa.eu/sites/default/documents/files/documents/10180/1156219/9c8ac238-4882-4a08-

As already noted, Pillar 2 measures, which may be quantitative (e.g. addressing capital or liquidity) or qualitative (e.g. addressing governance, reporting or disclosure obligations) in nature, are listed under Article 104(1) CRD V, but the wording of the provision ('competent authorities shall have *at least* the power to…') suggests that the measures listed do not encompass all possible measures available to supervisory authorities. For one, supervisory authorities may not only apply the measures under CRD V Articles 104 and 105, but also in national law.[48] Furthermore, the SSM regulation provides that the ECB may make use of the powers under Article 16(2), which mimic those under Article 104 CRD V, but add the power to remove members of the management body of the credit institution.[49] In addition, the coexistence of CRD, which leaves Member States the option to provide further supervisory powers, and the SSM regulation, means that, if national law vests the (NCA) with further powers than those under Article 104 CRD V, the ECB may also make use of those powers under any of the enabling clauses under Article 9 SSM regulation.[50]

#### *18.3.2 Supervisory powers and macroprudential concerns*

The SREP and the Pillar 2 framework aims to supplement the generality of capital requirements with a more specific bank-by-bank assessment. It logically follows that the supervisory powers themselves, to be exercised to address Pillar 2 shortcomings, should have a bank-specific focus. The problem arises when, during its data-gathering and scoring exercises the supervisor detects a patterned behavior that connects with a specific risk, present across the system. The temptation may then be too strong to use SREP and Pillar 2 supervisory powers as a powerful lever to address a market-wide phenomenon, which belongs in the realm of the risks addressed via capital or liquidity requirements. The risk, then, is that Pillar 2 is used as just another Pillar 1. An early and significant example was the ECB Addendum to the ECB Guidance on non-performing loans.[51] The aim of the Addendum was to reinforce and supplement the already existing ECB Guidance on non-performing loans (NPL), which is legitimate, considering the size of the problem in the Eurozone, but it did so 'by specifying quantitative supervisory expectations concerning the minimum levels of prudential provisions expected for non-performing exposures'.[52] In order to meet those expectations, banks were required to write down *in full* non-performing exposures within a certain period of time. More important, the Addendum introduced a *direct link* between non-compliance with the newly introduced minimum prudential provisioning requirements, and the SREP outcome for individual banks. Thus, the supervisory authority would take into account unjustified deviations from those requirements, which were common to all institutions, in its assessment of the need to impose supervisory measures on *individual banks*. In doing so, the Addendum may have de facto turned supervisory expectations into an extra layer of general rules applicable to banks, using the SREP and supervisory powers as the means to press banks into compliance. To avert this risk, and return NPEs common risks to the realm of Pillar 1 requirements, the EU legislator adopted Regulation No 2019/630 of 17 April 2019 amending CRR as regards the minimum loss coverage for non-performing exposures.

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a940-7bc6d76397b6/EBA-GL-2015-07_EN_GL%20on%20failing%20or%20likely%20to%20fail.pdf?retry=1> accessed 13 September 2020. These Guidelines have been adopted under the CRD IV and BRRD regime and have to be interpreted or, if necessary, amended, in order to take into account the new CRD V and BRRD II legal framework.

[48] EBA 'SREP Guidelines', para 493.

[49] Art 16 (2)(m) Council Regulation (EU) conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions [2013] OJ L 287/63 (hereinafter: SSM Regulation).

[50] Thus, the ECB may directly exercise the further Pillar 2 powers under national law transposing CRD V, or give instructions to the NCAs to adopt pure national law Pillar 2 measures.

[51] ECB, 'Addendum to the ECB Guidance to banks on nonperforming loans: Prudential provisioning backstop for non-performing exposures', (October 2017) <https://www.bankingsupervision.europa.eu/legalframework/publiccons/pdf/npl2/ssm.npl_addendum_draft_201710.en.pdf> accessed 13 September 2020.

[52] ibid.

A further, related problem can arise if the pattern emerging during the SREP exercise involves risks that cannot be pinned down to specific institutions, but threaten the whole system, i.e. systemic risks, which are typically addressed via macroprudential measures. In light of the previous explanation, Pillar 2 measures' bank-specific focus means that they are not conceived to be used for macro-prudential purposes.[53] Indeed, the use of the Pillar 2 measures to address macro-prudential concerns may also (a) undermine the allocation of competences between competent and designated authorities[54] and (b) impair the effectiveness and efficiency of the instruments expressly intended in the CRD V for macro-prudential purposes.[55] This, however, was unclear due to some friction between former CRD and SSM provisions. Under CRD IV the use of Pillar 2 measures for macro-prudential purposes was anchored on the wording of Articles 103(1), which allowed, and even promoted, supervisory authorities' pattern-seeking and identification as part of the SREP[56] and 105, which used 'systemic liquidity' conditions as a framework to assess individual banks' liquidity requirements.[57] CRD V repealed the above-mentioned Article 103 and deleted Article 105's reference to the 'systemic liquidity risk' as a relevant factor to determine the relevant requirement. Thus, it will be no longer possible to use Pillar 2 capital requirements to address macro-prudential concerns.

This means a potential for friction with the parts of the supervisory framework that have not been correspondingly amended. This should be easier in the case of EBA guidelines on SREP and Pillar 2 measures, which are clearly hierarchically inferior, and should be amended to take account of the new CRD V regime or be reinterpreted accordingly. More difficult is the relationship between CRD V regime of Pillar 2 measures and the SSM rules. Article 16(2) of the SSM regulation refers to the purposes of Article 9(1), which in turn makes reference to *both* the tasks under Articles 4 (tasks conferred on the ECB) and 5 (*macroprudential* tasks and tools). Thus, under SSM rules Pillar 2 measures mentioned in Article 16 SSM regulation could be used for both micro- and macro-prudential purposes. Yet, this is not in line with the new Pillar 2 regime under the CRD V. Unlike the ECB, the NCAs may make use of Pillar 2 powers under the conditions laid down under the national laws transposing CRD V, which are expected not to allow any use of Pillar 2 measures to address macro-prudential concerns. In principle, this may create a problem of misalignment between the macro-prudential powers of the ECB and the current powers of the NCAs, and a problem of coordination with Article 5 of the SSM regulation. Article 5 of the SSM Regulation itself, where it refers – not only to the National Designated Authorities (NDAs )– but also to the NCAs for the adoption of macro-

[53] See Recital 14 of CRD V: '…The institution-specific nature of additional own funds requirements should prevent their use as a tool to address macroprudential or systemic risks. However, that should not preclude competent authorities from addressing, including by means of additional own funds requirements, the risks incurred by individual institutions due to their activities, including those reflecting the impact of certain economic and market developments on the risk profile of an individual institution'.

[54] See the explanatory memorandum of the Proposal amending CRD IV, 11:
'Recent experience has shown that there would be merit in a clearer delineation of the areas of responsibility between competent and designated authorities. This applies notably to the supervisory review and evaluation process (SREP) and the corresponding supervisory requirements. Competent authorities are responsible for the SREP and the imposition of corresponding institution-specific supervisory requirements (so-called P2R). In this context, they may also evaluate systemic risk stemming from a specific institution and could address such risk by imposing supervisory requirements to this institution'.

[55] ibid, 11: 'The use of Pillar 2 measures may in this context undermine the effectiveness and efficiency of other macro-prudential instruments. Against this background, the proposal provides that the SREP and corresponding supervisory requirements should be confined to a purely micro-prudential perspective'.

[56] CRD IV before 2019, Art 103(1) stated that: 'where the competent authorities determine under Article 97 that institutions with similar risk profiles such as similar business models or geographical location of exposures, are or might be exposed to similar risks or pose similar risks to the financial system, they may apply the supervisory review and evaluation process referred to in Article 97 to those institutions in a similar or identical manner. For those purposes, Member States shall ensure that competent authorities have the necessary legal powers to impose requirements under this Directive and under Regulation (EU) No 575/2013 on those institutions in a similar or identical manner, including in particular the exercise of supervisory powers under Articles 104, 105 and 106'.

[57] CRD IV before 2019, Art 105 stated that: 'For the purposes of determining the appropriate level of liquidity requirements on the basis of the review and evaluation carried out in accordance with Section III, the competent authorities shall assess whether any imposition of a specific liquidity requirement is necessary to capture liquidity risks to which an institution is or might be exposed, taking into account… (d) systemic liquidity risk that threatens the integrity of the financial markets of the Member State concerned'.

prudential measures, seems no longer in line with the new regulatory framework contained in the CRD V. Thus, although the ECB could theoretically resort to Pillar 2 powers also for macro-prudential purposes under the SSM Regulation, it would be limited in their use by the CRD framework, due to the very nature of the top-up power at its disposal, which should not be broader than the powers of NCAs or national designated authorities.

Yet again, the issue can be more complex. The ECB (or NCAs) may be precluded from using the supervisory powers that stem from the SREP as a pure macroprudential tool, e.g. to top up other such tools, such as the countercyclical or systemic risk buffers with additional buffers, and impose an extra layer of capital (or liquidity requirements) across the board. It is a different matter if the ECB (or NCA) identifies a source of systemic risk, which may affect banks in a differentiated manner, depending on its exposure to the risk,[58] or its positioning in the bank network.[59] In that case the systemic risk would be part of the assessment of the bank's individual risk. As a final twist, however, some capital measures used for macroprudential purposes may be open to the ECB's scrutiny (e.g. the Capital Conservation Buffer), while the others remain within the exclusive authority of the NCA. This also limits the ECB's leeway, cautions against unilateralism, and requires enhanced dialogue between ECB and NCAs.[60]

#### *18.3.3 Supervisory powers, 'soft' and 'preventive' tools.*

Supervisory powers are 'hard' tools, which tend to be automatically associated with the enforcement of supervisory standards exercised by authorities through the SREP. Yet, an important part of the Pillar 2 framework is formed by 'soft' measures, such as P2G, and relies not on requirements imposed from the outside, by supervisory authorities, but on the institution's ability to self-monitor through strategies and processes to assess and maintain on an ongoing basis the necessary amounts, types and distribution of internal capital to cover the risks they are exposed to, i.e. the ICAAP.[61] Recovery plans, drafted by the institution, also form part of this (partially) self-monitoring framework.[62] Therefore, the relationship between 'hard' supervisory powers and 'soft' and/or 'preventive' measures is a relevant one.

Under the ICAAP framework, institutions' internal capital must be adequate to absorb potential losses including those identified under the supervisory stress test,[63] and supervisory authorities assess whether this level of internal capital is appropriate and adopt a guidance on additional own funds.[64] Furthermore, as seen before, a crucial part of the SREP for the third and fourth elements (capital and liquidity risks) consists in challenging the institution's internal assessment in general, and its stress tests in particular, both undertaken under its ICAAP (also under ILAAP).[65] Since stress testing

[58] That, for example, may be the case with climate-related risks, encompassing not only those associated to climate change (i.e. climate shocks), but also to sudden changes in policy that affect firms unevenly (policy shocks), which pose a systemic risk. See A group of the ESRB Advisory Scientific Committee, 'Too late, too sudden: Transition to a low-carbon economy and systemic risk' (2016) Reports of the Advisory Scientific Committee, No. 6 <https://www.econstor.eu/bitstream/10419/193616/1/Reports-ASC-6.pdf> accessed 14 September 2020. At the same time, the pervasive presence of such systemic risk may influence the risk profile in individual institutions and result in different Pillar 2 measures. See ECB, 'Guide on climate-related and environmental risks. Supervisory expectations relating to risk management and disclosure' (May 2020) (which frame the largely within the SREP, with reference to the supervisory expectations with regard to business model and strategy, governance and risk appetite, risk management, etc.) <https://www.bankingsupervision.europa.eu/legalframework/publiccons/pdf/climate-related_risks/ssm.202005_draft_guide_on_climate-related_and_environmental_risks.en.pdf> accessed 14 September 2020.

[59] Antonio Cabrales, Piero Gottardi and Fernando Vega-Redondo, 'Risk-Sharing and Contagion in Networks' (2017) 30 *Rev of Fin Studies*, 3086-3127.

[60] See article 5 (1) and (2) SSM Regulation.

[61] Art 73 CRD.

[62] Art 5 BRRD.

[63] Art 100 CRD.

[64] P2G, specific to each institution, shall set the own funds exceeding the Pillar 1 capital, large exposures and leverage requirements, the Pillar 2 own funds requirement and the combined buffer requirement or the leverage ratio buffer requirement.

[65] Paragraph 18.2.

ensures a forward-looking perspective in the assessment of an institution's capital needs, such forward-looking perspective may not only recommend the adoption of 'guidance', but also additional measures, if sufficiently alarming.

This connection between ICAAP and authorities' exercise of supervisory powers through stress-testing was envisaged in the EBA's guidelines on SREP and Pillar 2 measures,[66] and then given an explicit legislative basis by CRD V.[67] Thus, although failure to meet the P2G does not automatically trigger conservation measures,[68] under the EBA Guidelines, if the quantitative outcomes of stress tests indicate that the institution is likely to breach its capital requirements under the adverse scenario within the following 12 months, the authorities can use this as a basis[69] for additional supervisory measures.[70] Under the new legislative framework, if an institution repeatedly fails to establish or maintain an adequate level of additional own funds to cover P2G, the supervisory authority may apply an additional own funds requirement.[71] Since Pillar 2 'guidance' is either binding or it is not, a lot depends on the specific circumstances, which is why the new provisions require the authorities to justify the reasons for the additional requirements, including why P2*G* (emphasis on the 'G') is no longer sufficient.[72]

**18.4 Supervisory powers and other extraordinary measures based on the SREP findings (II). The relationship with early intervention and resolution**

In addition to Pillar 2 measures, competent authorities may apply early intervention measures as specified in Article 27 BRRD II,[73] which are intended to supplement the set of supervisory measures specified in Articles 104 to 105 of CRD V and, with regard to the SSM, also those specified in Article 16 SSM regulation. Measures under Article 27 BRRD II may be used where 'an institution infringes or, due, inter alia, to a rapidly deteriorating financial condition, including deteriorating liquidity situation, increasing level of leverage, non-performing loans or concentration of exposures, as assessed on the basis of a set of triggers, which may include the institution's own funds requirement plus 1,5 percentage points, is likely in the near future to infringe' the requirements provided for under the CRD V and Capital Requirements Regulation II (CRR II).[74] Therefore, the coordination between the framework of supervisory measures to address shortcomings identified under the SREP, and the

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[66] EBA 'SREP Guidelines', para 407, in connection with para 383.
[67] Arts 104a and 104b CRD, as introduced by CRD V.
[68] Arts 141-141b CRD as drafted by CRD V.
[69] Under Art 102(1)(b) CRD IV.
[70] EBA 'SREP Guidelines'. If an ICAAP is considered reliable (para 356) its quantitative outcomes for stress tests are used to assess capital adequacy under stressed conditions (para 383), and the size of P2G in general (para 394). When those stress tests indicate that the institution shall not be able to meet capital requirements under stress conditions, the institution shall submit a credible capital plan to address those deficiencies (para 402) but can also adopt additional measures when the outcome of stress tests (partly based on ICAAP) indicate an imminent breach (para 407).
[71] Art 104a(1)e CRD V with reference to art 104b(3) CRD V.
[72] Art 104° (5) CRD V provides that: 'The competent authority shall duly justify in writing to each institution the decision to impose an additional own funds requirement under point (a) of Article 104(1), at least by giving a clear account of the full assessment of the elements referred to in paragraphs 1 to 4 of this Article. That justification shall include, in the case set out in point (e) of paragraph 1 of this Article, a specific statement of the reasons for which the imposition of guidance on additional own funds is no longer considered sufficient'.
[73] These measures include the powers to: '(a) require the management body of the institution to implement one or more of the arrangements or measures set out in the recovery plan or in accordance with Article 5(2) to update such a recovery plan when the circumstances that led to the early intervention are different from the assumptions set out in the initial recovery plan and implement one or more of the arrangements or measures set out in the updated plan within a specific timeframe and in order to ensure that the conditions referred to in the introductory phase no longer apply; (b) require the management body of the institution to examine the situation, identify measures to overcome any problems identified and draw up an action programme to overcome those problems and a timetable for its implementation; (c) require the management body of the institution to convene, or if the management body fails to comply with that requirement convene directly, a meeting of shareholders of the institution, and in both cases set the agenda and require certain decisions to be considered for adoption by the shareholders; (d) require one or more members of the management body or senior management to be removed or replaced if those persons are found unfit to perform their duties pursuant to Article 13 of Directive 2013/36/EU or Article 9 of Directive 2014/65/EU; (e) require the management body of the institution to draw up a plan for negotiation on restructuring of debt with some or all of its creditors according to the recovery plan, where applicable; (f) require changes to the institution's business strategy; (g) require changes to the legal or operational structures of the institution; and (h) acquire, including through on-site inspections and provide to the resolution authority, all the information necessary in order to update the resolution plan and prepare for the possible resolution of the institution and for valuation of the assets and liabilities of the institution in accordance with Article 36'.
[74] Regulation (EU) No 648/2012 (CRR II) [2019] OJ L 150/1.

early intervention measures regulated under the resolution framework, as well as with the resolution framework itself, is crucial to ensure a seamless transition from red flags to crisis management. We discuss first (i) the framework of early intervention, and its relationship with supervisory measures, including the triggers; (ii) then some specific measures, including the removal of management, and then (iii) the relationship between supervisory measures and the resolution framework itself.

#### *18.4.1 Supervisory measures and early intervention. Context and triggers.*

In light of the EBA Guidelines on triggers for use of early intervention measures under Article 27 BRRD,[75] 'the assessment of whether an institution "infringes or is likely to infringe in the near future" the requirements of Regulation (EU) No 575/2013 or of Directive 2013/36/EU is carried out by the competent authorities based on their comprehensive assessment, including by means of SREP as described in Article 97 of Directive 2013/36/EU and further specified in the SREP Guidelines'.[76]

Triggers for the application of early intervention measures under Article 27 BRRD are:[77] (a) an overall SREP score and pre-defined combinations of the Overall SREP score and scores for individual SREP elements; (b) material changes or anomalies identified in the monitoring of key financial and non-financial indicators under SREP revealing that the conditions for early intervention are met; (c) significant events indicating that the conditions for early intervention are met. In particular, competent authorities may decide on the application of early intervention measures, in case of the Overall SREP of '4' (the risks identified pose a high level of risk to the viability of the institution) or a combination of the Overall SREP score of '3' (the risks identified pose a medium-high level of risk to the viability of the institution) and SREP elements score of '4'.[78] As for the material changes or anomalies identified in the monitoring of key financial and non-financial indicators, the Guidelines indicate that 'competent authorities need to identify indicators and set thresholds that are relevant to the specificities of individual institutions or groups of institutions sharing similar characteristics (peer groups)', and that 'When identifying thresholds for the indicators related to prudential requirements', competent authorities 'should consider both minimum and additional requirements' under the CRR and Article 104 CRD V.[79]

Triggers include capital and liquidity requirements, but do not mention 'leverage'. As the new CRR II and CRD V framework also provides for a leverage ratio, the Guidelines need to be amended in order to include reference to the latter. Significant events triggering the application of early intervention measures under Article 27 BRRD include, among others, according to the EBA Guidelines: significant deterioration in the amount of eligible liabilities and own funds held by an institution for the purposes of meeting the minimum requirements for own funds and Minimum Required Eligible Liabilities (MREL); the fact that a resolution authority commences a consultation process with a competent authority while determining whether an institution is 'failing or likely to

[75] Under Art 27(4) of BRRD 'EBA shall, by 3 July 2015, issue guidelines in accordance with Article 16 of Regulation (EU) No 1093/2010 to promote the consistent application of the trigger for use of the measures referred to in paragraph 1 of this Article'. Moreover, under paragraph 5, 'taking into account, where appropriate, experience acquired in the application of the guidelines referred to in paragraph 4, EBA may develop draft regulatory technical standards in order to specify a minimum set of triggers for the use of the measures referred to in paragraph 1 (firs sub-paragraph). Power is delegated to the Commission to adopt the regulatory technical standards referred to in the first subparagraph in accordance with Articles 10 to 14 of Regulation (EU) No 1093/2010 (second sub-paragraph)'. See EBA, 'Guidelines on triggers for use of early intervention measures pursuant to Article 27(4) of Directive 2014/59/EU' (29 July 2015) <https://eba.europa.eu/sites/default/documents/files/documents/10180/1067473/f6234078-a8cb-40a1-88f1-f22d446ca394/EBA-GL-2015-03%20Guidelines%20on%20Early%20Intervention%20Triggers.pdf?retry=1> (hereinafter: EBA Guidelines on Early Intervention Triggers).

[76] EBA 'Guidelines on Early Intervention Triggers', section 4.

[77] EBA 'Guidelines on Early Intervention Triggers', section 7.

[78] In the assessment of the individual SREP elements, competent authorities should use a range of scores - 1 (low risk), 2 (medium-low risk), 3 (medium-high risk), and 4 (high risk) – reflecting the supervisory view based on the relevant scoring tables in each element-specific title (para 33 of the SREP Guidelines).

[79] EBA 'Guidelines on Early Intervention Triggers', paras 17-18.

fail' (such a situation may occur when the resolution authority is empowered to determine that an institution is FOLTF pursuant to Article 32 of Directive 2014/59/EU). In certain circumstances, material changes or anomalies in indicators or significant events may be directly used as triggers for the decision on the application of early intervention measures without the need for updating the SREP assessment.

The use of early intervention measures under Article 27 BRRD II is without prejudice of that of Pillar 2 ones for the same purposes, which requires an integrated view to ensure consistency, and an adequate transition between triggers. Pillar 2 measures may be used, under Article 102 CRD V and Article 16(1)(a) and (b) SSM regulation as early intervention measures, where: (a) the institution does not meet the requirements of CRD V or of CRR II;[80] (b) the competent authorities have evidence that the institution is likely to breach the requirements of CRD V or of CRR II within the following 12 months. Moreover, under Article 16(1)(c) SSM regulation ECB may make use of Pillar 2 instruments as early intervention measures, 'based on a determination, in the framework of a supervisory review in accordance with point (f) of Article 4(1), that the arrangements, strategies, processes and mechanisms implemented by the credit institution and the own funds and liquidity held by it do not ensure a sound management and coverage of its risks'. This special provision under Article 16(1)(c) SSM regulation creates a misalignment with respect to the requirements for the use of Pillar 2 powers for the adoption of early intervention measures, which under the CRD V are subject to stricter requirements than the mere emergence - within the SREP - of situations where the institution 'do not ensure a sound management and coverage of its risks'.

***18.4.2 Specific measures, removal of management.***

The first early intervention measure mentioned in Article 27(1) BRRD II is the implementation of the recovery plan. This come as no surprise, considering the synergies and complementarity of the analysis between the SREP and the recovery plans assessment as outlined in the EBA Guidelines on SREP and Pillar2 measures[81]. Yet, perhaps the more controversial measures may be those related to the power under Article 27 (1) (d) BRRD to 'require one or more members of the management body or senior management to be removed or replaced if those persons are found unfit to perform their duties pursuant to Article 13 of Directive 2013/36/EU or Article 9 of Directive 2014/65/EU'. In order to understand the exact scope of the provision one has also to refer to Articles 28 and 29 BRRD II, specifying the conditions for the application of the collective removal and the special administration respectively. In light of the above, one may argue that EU law provides for a hierarchy of measures. In a crescendo of seriousness, the supervisory authority may make use of the early intervention power under Article 27(1)(d) and, where this powers prove not sufficient to address the situation, it may resort to the collective removal under Article 28 or the special administration under Article 29 BRRD. This latter is subject in part to the same conditions as the collective removal (the serious violations of legislative or statutory provisions or the serious irregularities in the administration), so that in these cases the supervisory authority has to assess which of these two tools better allows for the recovery of a sound and prudent management.

[80] In this case, early intervention measures should be qualified as administrative measures and subject to the same regime, as they follow to a violation of a rule and have a reparatory aim. While safeguards applicable to supervisory decisions are confined to the statement of reasons and the right to be heard, including the access to files, it is a matter of debate whether additional safeguards apply to the administrative measures (special rules are laid down in some EU regulations).

[81] EBA 'Guidelines on Early Intervention Triggers', 14-15. See **Paragraph 18.2**.

If the authority believes that - despite the unfitness of the management in charge - the shareholders may appoint a management capable of achieving the economic rebalancing of the bank, it will merely remove the managers. On the contrary, if it considers that there are no alternatives – in view of the credit institution's recovery – to a vicarious management that temporarily replaces or suspends the corporate bodies, it will be inclined to adopt a temporary administration decision.

This legal framework is complemented, with reference to the SSM, by the rule under Article 16(2)(m) SSMR, which confers to the ECB the (Pillar 2 and early intervention) power to remove at any time members from the management body of credit institutions who do not fulfill the requirements set out in the acts referred to in the first subparagraphs of Article 4(3) (i.e., relevant Union law and national legislations transposing Directives). This provision could be interpreted narrowly, referring only to the fit and proper framework, so that the ECB has the power to remove managers who do not meet the reputation and competence requirements. Alternatively, given the wide reference to all the relevant EU law contained in Article 16(2)(m), one may go so far as to consider the ECB's power of removal as extended to all cases where the managers of the supervised entity, though compliant with the fit and proper requirements, act in prejudice of the sound and safe management of the bank.

#### *18.4.3 Supervisory measures and resolution authorities and framework.*

Although the conditions for the use of early intervention measures under Article 27 BRRD II are not perfectly aligned with those under Articles 102 CRD V and 16(1) SSMR and the latter are not qualified as crises intervention measures under the BRRD II,[82] the ECB and NCAs have to inform the Single Resolution Board (SRB) and National Regulatory Authorities (NRAs) of any early intervention measure adopted directly by the authorities, or required by them to the bank under the SSM Regulation, the BRRD II or the CRD V.[83] Outside the Banking Union (SSM/Single Resolution Mechanism (SRM)) framework the same information duties apply,[84] and the same powers can be activated by resolution authorities.

Indeed, within the SRM, following the notification from supervisory authorities, the SRB or, with regard to the LSIs, the NRAs may: (a) prepare for the resolution; (b) require the bank or the parent institution to start looking for potential purchasers; (c) require national resolution authorities to draft a preliminary resolution scheme for the bank or group.[85] Outside the SRM, Article 27(2) BRRD II requires the States to ensure that 'the powers of the resolution authorities include the power to require the institution to contact potential purchasers in order to prepare for the resolution of the institution, subject to the conditions laid down in Article 39(2) and the confidentiality provisions laid down in Article 84'.

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[82] Under Art 2(1) point (101) BRRD, 'crisis prevention measure' means the exercise of powers to direct removal of deficiencies or impediments to recoverability under Art 6(6), the exercise of powers to address or remove impediments to resolvability under Art 17 or 18, the application of an early intervention measure under Art 27, the appointment of a temporary administrator under Art 29 or the exercise of the write down or conversion powers under Art 59 BRRD.

[83] Including Arts 104 CRD V and Art 16 SSM regulation. See Art 13(1) SRM regulation and Art 81(2) BRRD. Coherently, under Art 27(1)(h) **??** supervisory authorities are empowered to 'acquire, including through on-site inspections and provide to the resolution authority, all the information necessary in order to update the resolution plan and prepare for the possible resolution of the institution and for valuation of the assets and liabilities of the institution in accordance with Article 36'.

[84] Under Art 27(2) BRRD II, 'Member States shall ensure that the competent authorities shall notify the resolution authorities without delay upon determining that the conditions laid down in paragraph 1 have been met in relation to an institution'. Moreover, under Art 81(2) BRRD II, 'competent authorities shall inform the relevant resolution authorities… of any crisis prevention measures, or any actions referred to in Article 104 of Directive 2013/36/EU they require an institution or an entity referred to in point (b), (c) or (d) of Article 1(1) of this Directive to take'.

[85] See Arts 7(3), forth sub-paragraph, and 13 SRM regulation. Within the SRM, the activation by the SRB or the NRAs of the resolution powers following the notification by the ECB or the NCAs of any early intervention measures, including those under Art 104 CRD, is provided for under Art 13 SRM regulation, recalled, as far as the NRAs are concerned, by Art 7(3), forth sub-paragraph, SRM regulation.

It is not clear, however, whether, outside the SSM/SRM, the powers that can be activated by the resolution authorities result only from the communication of the triggers of early intervention measures pursuant to Article 27 BRRD II or also those pursuant to Articles 102 and 104 CRD V. A further and more general question is whether a broad interpretation of the early intervention measures would contradict the proportionality principle as well as the purpose of the notification requirement, which is to avoid the failure of an institution and ensure the timely involvement of the resolution authority to prepare for resolution, given that, at least within the SRM, such measures include no crisis-prevention measures as the supervisory measures under Article 104 CRD V.

The confusion between these two types of measures (those under Article 27 BRRD II and those under Articles 102/104 CRD V and 16 SSM regulation) might create a twofold negative effect as it could: (a) prevent or delay the adoption of the ordinary preventive supervisory measures, due to the fear of triggering the different consequences envisaged by the BRRD II (e.g. notification to the Resolution Authority that could, in turn, cause market reactions and intensify pressures on the bank); (b) determine undesirable impacts on banks, should ordinary supervisory measures be framed as early intervention measures (e.g. market reactions in case the Market Authority discloses to the market the adoption of an early intervention measure).[86]

Finally, it is important to assess the relationship between SREP and supervisory measures, and the assessment that an institution is FOLTF. The criteria for the FOLTF assessment are specified in the EBA Guidelines,[87] which also apply to FOLTF assessments for purposes of exercising the write-down and/or conversion power,[88] and are addressed to supervisory authorities, resolution authorities[89], and to institutions, where they do the FOLTF assessment themselves.[90]

When making a FOLTF assessment under Article 32(4)(a) to (c) of BRRD II, supervisory or resolution authorities assess the objective elements relating to: the capital position of an institution; the liquidity position of an institution; and any other requirements for continuing authorization (including therefore governance arrangements and operational capacity). Should the supervisory authority assess as part of SREP an institution as not being viable (as expressed in an Overall SREP score 'F'), it would lead to an FOLTF assessment. Furthermore, the inability of an institution to comply with previous supervisory and/or early intervention measures may indicate that such tools have been exhausted, and help justify a FOLTF assessment as well.

Under Article 32(4), first subparagraph, lit. (d), BRRD II, an institution shall be deemed to be failing or to be likely to fail, when, among others, 'extraordinary public financial support is required except where, in order to remedy a serious disturbance in the economy of a Member State and preserve financial stability, that extraordinary public financial support takes any of the following forms: … (iii) an injection of own funds or purchase of capital instruments at prices and on terms that do not

[86] A general concern on this topic has been expressed by the European Commission, 'Report from the Commission to the European Parliament and the Council on the Single Supervisory Mechanism established pursuant to Regulation (EU) No 1024/2013 [2017] 17 <https://ec.europa.eu/info/sites/info/files/171011-ssm-review-report_en.pdf> accessed 14 September 2020: 'when early intervention measures are planned to be taken by the ECB with regard to a supervised institution for which SRB is the resolution authority, such measures should be notified to the SRB, which may prepare for the resolution of the institution concerned and, together with the ECB, shall closely monitor the compliance with the early intervention measures. Some inconsistencies in the legal framework for early intervention measures have been observed and could be addressed by clarifying the use of early intervention powers where they overlap with supervisory powers'.

[87] EBA, 'Guidelines on the interpretation of the different circumstances when an institution shall be considered as failing or likely to fail under Article 32(6) of Directive 2014/59/EU' (26 May 2015) <https://eba.europa.eu/sites/default/documents/files/documents/10180/1085517/02539533-27ed-4467-b442-7d2fa6fcb3d3/EBA-GL-2015-07%20GL%20on%20failing%20or%20likely%20to%20fail.pdf?retry=1> accessed 14 September 2020.

[88] Art 60 of BRRD II.

[89] Normally, supervisory authorities are competent to declare the FOLTF under Article 32(1)(a), but resolution authorities are also competent under Article 32(2) of BRRD II.

[90] Art 81(1) of BRRD II.

confer an advantage upon the entity, where neither the circumstances referred to in points (a), (b) and (c) of this paragraph nor the circumstances referred to in Article 21(1) are present at the time the public support is granted'. In this case, support measures 'shall be limited to injections necessary to address capital shortfall established in the national, Union or SSM-wide stress tests, asset quality reviews or equivalent exercises conducted by the ECB, EBA or national authorities, where applicable, confirmed by the competent authority'.

It is unclear whether the outcome of SREP may be included within the equivalent exercises revealing the need for said capital injections. As the stress test is part of SREP and a separately organized Asset Quality Review (AQR) may be taken into account in the SREP assessment, there should be no logical contraindications to include the SREP itself in the list of instruments that can be used to ascertain the capital contributions required for the extraordinary public recapitalization purposes. Rather, the problem would be to determine which SREP results can be considered for these purposes. Obviously excluded those triggering the FOLTF, which impedes the extraordinary precautionary public intervention, a further limit is represented by the fact that the support measures shall not be used to offset losses, resulting from the SREP, that the institution has incurred or is likely to incur in the near future.