

## Supervisory disclosure of criteria and methodologies used in the review and evaluation process of banks.

In accordance with Section 6(16)(c) of Act no. 483/2001 Coll. on banks, the National Bank of Slovakia publishes the general evaluation criteria and the methodology which it uses in the exercise of supervision over banks and branches of foreign banks. The obligation to disclose this information is laid down by Article 144 of Directive 2006/48/EC of the European Parliament and of the Council relating to the taking up and pursuit of the business of credit institutions (recast).

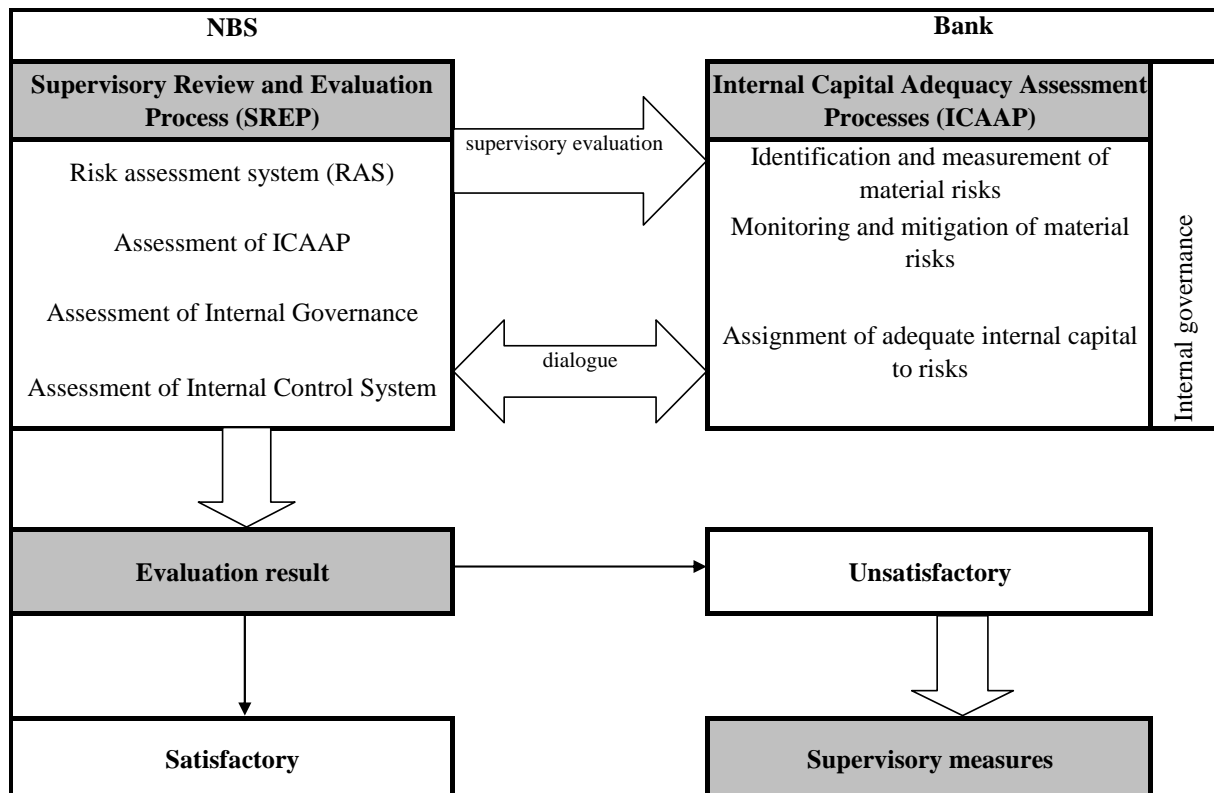
The Committee of European Banking Supervisors (CEBS) has agreed on a common framework for supervisory disclosure in order to make it possible to compare disclosures of different Member States. The content and structure of the disclosures are set out in the "CEBS Guidelines on Supervisory Disclosure."<sup>1</sup>

Supervisory disclosure is broken down into four parts:

- Scope of the application of the Supervisory Review and Evaluation Process (SREP);
- Framework of bank's individual risk assessment (RAS);
- Evaluation of banks' Internal Capital Adequacy Assessment Processes (ICAAPs);
- Supervisory measures

### 1. Scope of the application of the Supervisory Review and Evaluation Process (SREP)

The Supervisory Review and Evaluation Process involves evaluating a bank's risk profile, organization and management system and its internal control and governance system, and assessing the adequacy of internal capital on the basis of an evaluation of the bank's Internal Capital Adequacy Assessment Process. A scheme of the SREP is shown below.



<sup>1</sup> [www.c-eps.org/standards.htm](http://www.c-eps.org/standards.htm)

## 1.1 Classification of institutions

For the purposes of supervision, banks and branches of foreign banks are divided into four groups:

- large
- small and medium-sized
- building society savings banks
- branches of foreign banks

Group	Group characteristics	
large banks	quantitative criterion	- balance sheet total of more than SKK 100 billion - large volume of primary deposits
	qualitative criterion	- universal bank with a broad range of banking activities
small and medium-sized banks	quantitative criterion	- balance sheet total of less than SKK 100 billion - smaller volume of primary deposits
	qualitative criterion	- narrower range of banking activities or activities with a special focus
building societies	a bank performing activities in accordance with Act no. 310/1992 Coll. on building savings	

## 1.2 Application of the Supervisory Review and Evaluation Process (SREP)

Every bank supervised by the National Bank of Slovakia, whether on an individual or consolidated basis, is included in the Supervisory Review and Evaluation Process. Where a bank has a parent company whose registered office is in another Member State, the only part of the consolidated unit that will be included in the SREP is the bank incorporated in Slovakia and its subsidiaries. Branches of foreign banks come under supervision within the scope of the competences of the host Member State, as laid down in Section 16 of Act no. 483/2001 Coll. on banks.

## 1.3 Application of the proportionality principle

When implementing the SREP, the National Bank of Slovakia applies the proportionality principle, including the following three basic criteria:

- size of the bank;
- scale and complexity of its activities;
- the bank's importance to financial sector stability.

## 1.4 Cooperation with other regulators

The National Bank of Slovakia cooperates actively with the supervisory authorities of Member States on the basis of Directive 2006/48/EC of the European Parliament and of the Council relating to the taking up and pursuit of the business of credit institutions, as well as the rules laid down by the CEBS in "Guidelines for Cooperation between the Consolidating Supervisors and Host Supervisors."<sup>1</sup>

Cooperation is also based on rules laid down in Memoranda of Understanding agreed between the National Bank of Slovakia and foreign supervisory authorities. Memoranda of Understanding concerning cooperation in the field of banking supervision have so far been signed with nine foreign supervisors.

The Memoranda of Understanding constitute a general framework of cooperation, and each covers information exchange on a voluntary and reciprocal basis. Information exchange includes disclosures about legislation, licensing activities and the exercise of supervision. The Memoranda also allow for the home supervisor to conduct on-site supervision in the host supervisor's country.

## **2. Framework of bank's individual risk assessment (RAS)**

The evaluation of a bank's risk profile represents a core component of the Supervisory Review and Evaluation Process and lays the basis for evaluating the bank's Internal Capital Adequacy Assessment Process and for evaluating the qualitative requirements for the use of banks' internal models in the calculation of capital requirements.

The basis for evaluating a bank's risk profile is the legal framework regulating the requirements under which banks conduct business and the NBS's approved strategy for the exercise of supervision.

The legal framework within which supervision is exercised comprises mainly:

- Act no. 747/2004 Coll. on Financial Market Supervision,
- Act no. 483/2001 Coll. on Banks,
- Act no. 566/1991 Coll. on the National Bank of Slovakia,
- NBS decrees in the field of prudential banking business, in particular:
  - Decree of the NBS no. 12/2004 on risks and the risk management system, as amended,
  - Decree of the NBS no. /2007 on banks' own funds of financing and requirements for banks' own funds of financing,
  - Decree of the NBS no. 13/2004 on the classification of assets and liabilities, as amended,
  - Decree of the NBS no. 3/2004 on the liquidity of banks, as amended,
  - Decree of the NBS no. /2007 on disclosures by banks and branches of foreign banks

The framework for risk-oriented supervision is based on the NBS Strategy for the Exercise of Banking Supervision. A core document of this strategy is the Mission Statement for Banking Supervision, approved by the NBS Bank Board.

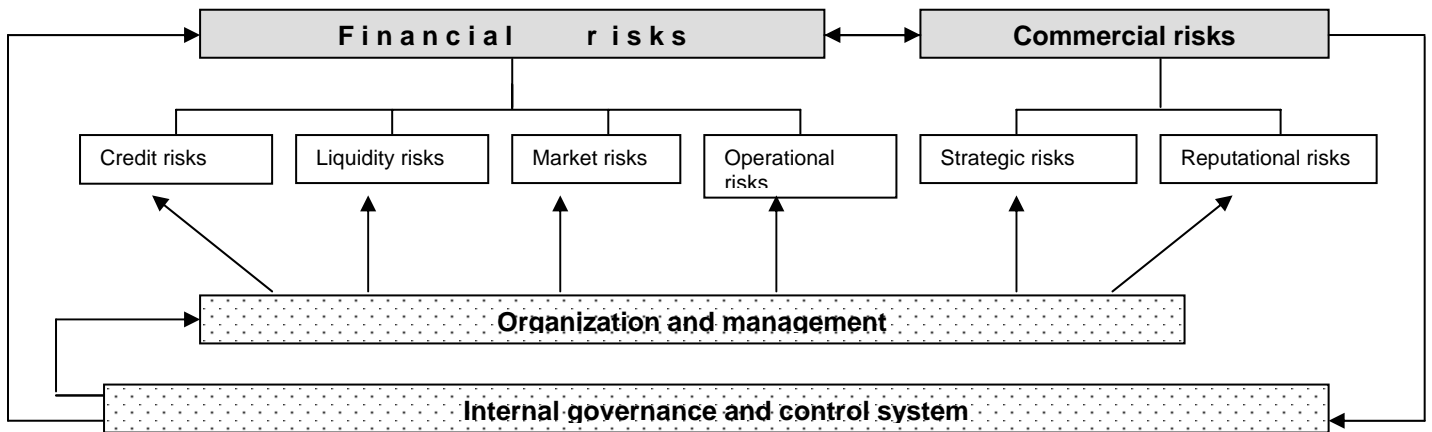
In order to meet the objectives and tasks laid down by the Mission Statement, banking supervision is governed by banking supervision policies. The evaluation of banks' risk profiles is based upon a supervisory policy focused on risk management, eventually a rating system for banks and the supervisory policy related to them.

The preparation, planning and focus of supervision from one bank to another are based on the evaluation of the given bank's risk profile. The principal risks evaluated are:

- credit risk
- market risk
- liquidity risk
- operational risk

- strategic risk
- reputation risk

A broader framework for the evaluation of each institution is provided by an assessment of the organization and management established in the bank as well as of the internal control and governance system.



## 2.1 Main supervisory components and tools

The main components of supervision are:

- off-site supervision
- on-site inspection
- cooperation with the auditor
- cooperation with the internal auditor

The main tools of supervision are:

- an analysis of the bank's financial position based on information from reports
- an analysis of significant changes in the bank's financial indicators
- an evaluation of the bank's risk profile – risk matrix
- the CAMEL rating
- the supervisory plan – inspection cycle

### Scheme showing how a risk profile is determined

Supervision component	Off-site supervision	On-site inspection
Output 1	Risk profile based on the evaluation of financial indicators (FINAN)	Risk profile based on the evaluation of the risk management system, the organization and management of the bank, and the internal control and governance system
Output 2	Final risk profile and final rating	
Output 3	Supervisory plan – inspection cycle	

### 2.1.1 The analysis of a bank's financial position based on information from reports, and the analysis of significant changes in its financial indicators

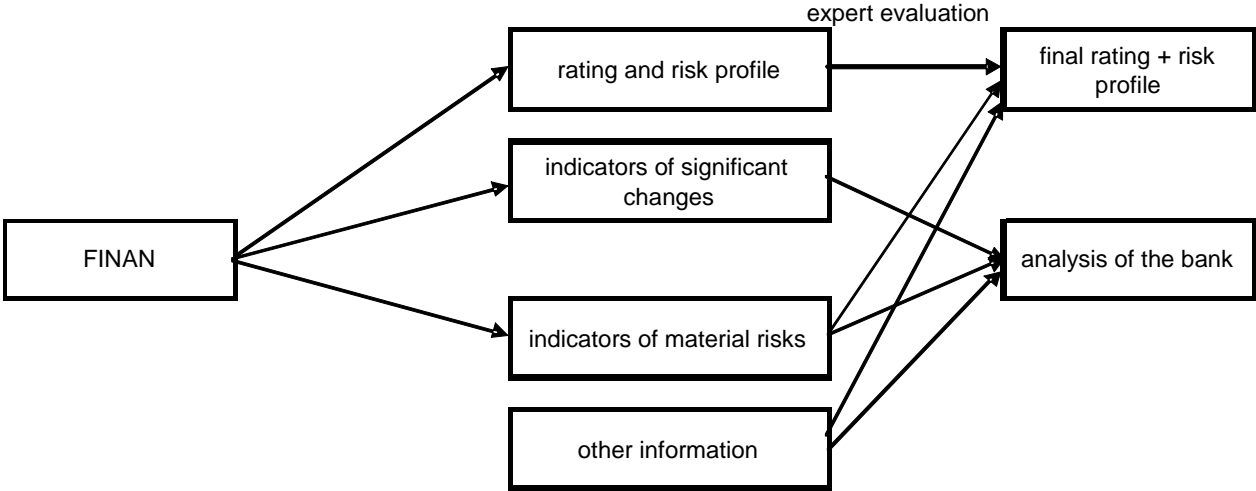
The analysis of individual banks is aimed at assessing the financial position of each bank, significant changes in its financial indicators, and its compliance with prudential rules.

The inputs for the analysis come from data and information which the NBS has at its disposal, especially:

- statements and statistical reports which banks send the NBS through the STATUS system
- information provided by banks at the request of the supervision department
- additional reports, special reports, and questionnaires, based on the recommendations and methodological instructions of the banking supervisor
- extended auditor's reports
- internal auditor's reports
- the bank's annual report
- publicly available information

The financial analysis and the analysis of significant changes are based on monitored values and monitored indicators - FINAN. From this set of monitored values, the following outputs are defined for the bank's evaluation:

- an automated rating
- an automated assessment of the level of significant risks
- indicators of significant changes
- indicators of material risks



The analysis of the financial position of individual banks and the analysis of significant changes is usually carried out on a quarterly basis.

**2.1.2 Evaluation of the bank's risk profile - risk matrix**

The evaluation of the bank's risk profile includes an assessment of the level of risk and the risk management system for the main risks – credit, operational, market, liquidity, strategic, and reputation. For each risk, numeric evaluations from 1 to 5 are assigned separately for the level of risk and for the risk management system. Each risk is also assigned an expected trend development (negative, positive, stable).

## RISK MATRIX

BANK			
RISK	LEVEL OF RISK	RISK MANAGEMENT	TREND
CREDIT			
OPERATIONAL			
MARKET			
LIQUIDITY			
REPUTATION			
STRATEGIC			

The level of risk for credit risk, market risk and liquidity risk is assessed on the basis of numeric indicators. Each indicator is assigned intervals of the evaluation values and each is assigned weight significance.

The level of risk for operational risk, strategic risk, and reputation risk is assessed using a combination of quantitative and qualitative indicators. The assessed areas for the said risks are shown in the following tables.

### Operational risk

Assessment of the level of operational risk
A. OPERATIONAL RISK IN COMMERCIAL ACTIVITIES
Loans, guarantees
Securities
Money market and foreign exchange market transactions
B. AUXILIARY, SERVICE AND CONTROL ACTIVITIES
IT and the bank's physical and systemic security
Accounting and reporting
AML

### Reputation risk

Assessment of reputation risk
Financial performance of the bank
Evaluation of the management and internal processes
Customer and public relations

### Strategic risk

Assessment of the strategic risk
Commercial strategy and objectives
Business environment

The risk management system for each risk is assessed during on-site supervision in accordance with the standardized assessment for the given area. The risk management system assessment for the different risks covers the areas shown in the following tables.

### Credit risk

Credit risk management system
Credit risk management strategy
Credit risk management organization
Information flows
Information system

System for concluding transactions and performing activities
Internal regulations
Identification of credit risk
Credit risk measurement
Credit risk monitoring and methods for setting limits
Credit risk mitigation
Internal control system

### **Operational risk**

<b>Operational risk management system</b>
Operational risk management strategy
Operational risk management organization
Information flows
Information system
Internal regulations
Identification of operational risk
Estimate of operational risk
Operational risk monitoring
Operational risk mitigation
Internal control system

### **Market risk**

<b>Market risk management system</b>
Market risk management strategy
Market risk management organization
Information flows
Information system
New types of transactions and activities
System for concluding transactions
Internal regulations
Market risk measurement
Market risk monitoring
Market risk mitigation
Internal control system

### **Liquidity risk**

<b>Liquidity risk management system</b>
Liquidity risk management strategy
Liquidity risk management organization
Internal regulations
The bank management's awareness of the liquidity situation
Information system
Methods and procedures for measuring and monitoring liquidity and methods and limits for mitigating liquidity risk
Liquidity management scenarios
Stabilization and diversification of financial funds and the realization of assets
Contingency plan
Internal control system

**Reputation risk**

<b>Assessment of the reputation risk management system</b>
Assumptions for risk management
Management system

**Strategic risk**

<b>Assessment of the strategic risk management system</b>
Assumptions for risk management
Management system

The assessment of the level of risk for credit risk, market risk, and liquidity risk is carried out on a quarterly basis (off-site risk profile). The evaluation of the bank's risk profile in terms of the overall risk matrix is usually carried out once a year; it is based on the conclusions of the on-site inspection and the numeric indicators calculated under off-site supervision.

**2.1.3 CAMEL rating**

The CAMEL rating covers the bank's capital, assets, management, earnings, liquidity and sensitivity. Each assessed area is assigned a final numeric evaluation from 1 to 5 and also an expected trend development (negative, positive, stable).

**CAMEL RATING**

<b>BANK</b>		<b>TREND</b>
<b>CAPITAL</b>		
<b>ASSETS</b>		
<b>MANAGEMENT</b>		
<b>EARNINGS</b>		
<b>LIQUIDTY</b>		
<b>SENSITIVITY</b>		
<b>FINAL RATING</b>		

Each assessed area (except for management) is assigned numeric indicators. Each indicator is assigned intervals of the evaluation values with a rating of 1 to 5, and each is assigned a weighting.

The management is evaluated mainly on the basis of on-site supervision; if an on-site inspection has not been conducted, the assessment will use information from off-site supervision (communication and cooperation with the bank) and from meetings with the bank's management.

The final rating is calculated as the average of the ratings for each assessed area, rounded to a whole number; it is a principle that the final rating may not be more than one grade higher than the area with the worst assessment.

A rating that excludes the management element is carried out on a quarterly basis (off-site rating). The full CAMEL rating is usually carried out once a year on the basis of conclusions from on-site supervision and the numeric indicators calculated under off-site supervision.

**2.1.4 Supervisory plan – inspection cycle**

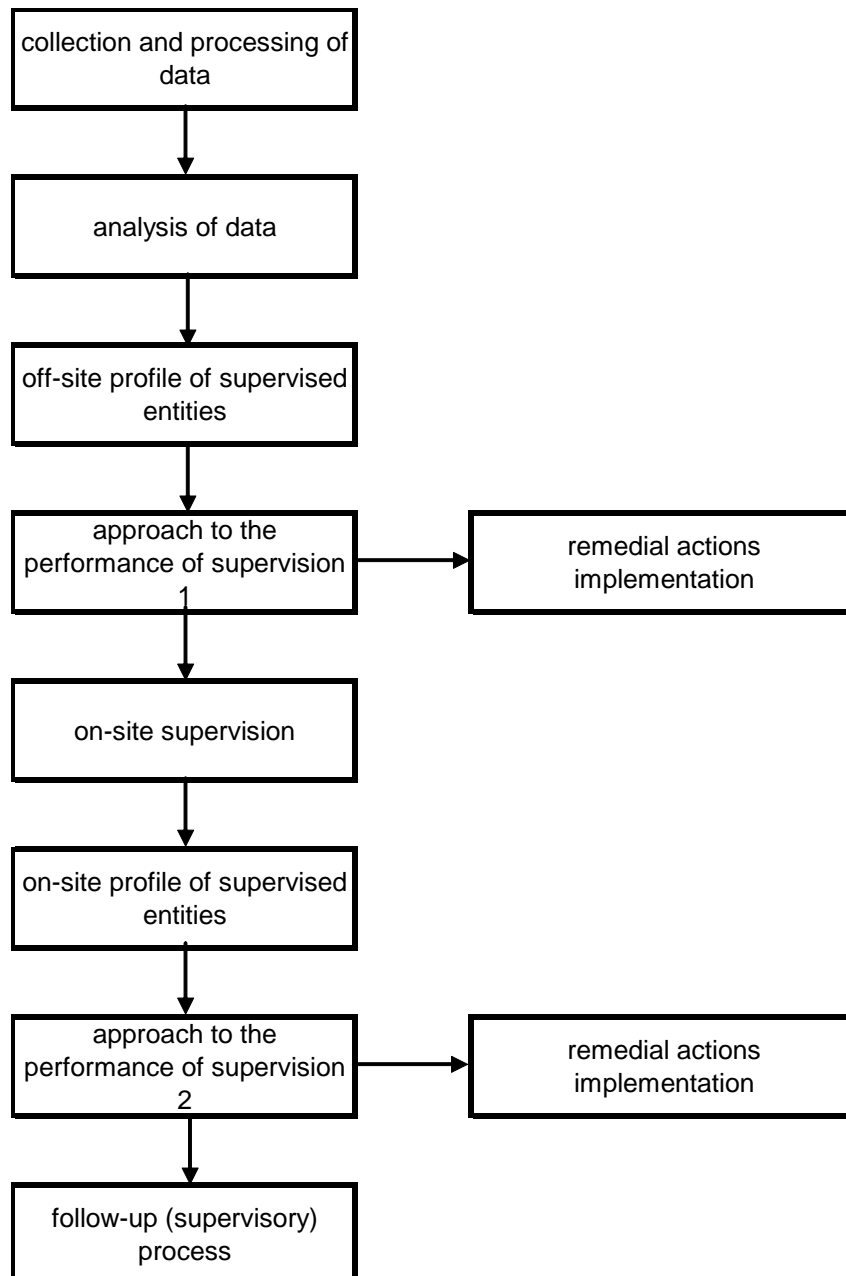
On the basis of the bank's risk profile and the final rating, a supervisory plan is drawn up for the bank and the inspection cycle is set (24, 12, 6 months, or continuous monitoring of the bank/special regime). The relationship between the bank's rating and the inspection cycle is shown in following table. The inspection cycle represents the frequency of the on-site inspections carried out in banks.

Rating of bank	cycle of 24 months	cycle of 12 months	cycle of 6 months	continuous monitoring / special regime
1	●			
2	●			
3		●		
4			●	
5				●

Apart from on-site inspections conducted within the inspection cycle, follow-up inspections are carried out within 12 months after the completion of each on-site inspection in order to verify the fulfilment of measures adopted by the bank in response to the on-site inspection.

**2.2 Tasks and competences in regard to the supervisory planning and preparation process**

The supervisory process is shown in following figure.



### 2.2.1 Off-site supervision

Off-site supervision includes collecting and processing information on banks (statements, reports, auditor's reports, internal auditor's reports, correspondence with the bank, other available information). On the basis of data analysis, off-site inspectors compile a risk profile of a bank for the purpose of planning its supervision and inspection cycle.

Based on the acquired information, the risk profile evaluation, and the evaluation of the fulfilment of prudential rules, off-site inspectors may take action against the bank in accordance with the nature of the identified errors and shortcomings (e.g. the breach of prudential limits, the incorrect or late submission of reports, breaches of other statutory obligations).

Off-site inspectors will provide on-site inspectors with supplementary information prior to the commencement of an on-site inspection and will initiate an examination based on the acquired and processed information about the bank.

Following completion of an on-site inspection, the inspected bank will submit a plan of measures for the rectification of shortcomings identified during the inspection. Off-site inspectors are responsible for assessing the fulfilment of this plan.

### **2.2.2 On-site inspection**

On-site supervision includes drawing up an annual on-site inspection plan based on the risk profile evaluation of the different banks, other available information, and in accordance with the inspection cycle stipulated for banks. The inspection plan includes the dates for commencing and conducting on-site inspections, the focus of the inspections, and the expected composition of the working groups that are to carry out the inspections.

There are 3 basic types of inspection carried out at banks:

- Comprehensive inspection
- Thematic inspection
- Follow-up inspection

A comprehensive inspection includes an evaluation of all the bank's main activities, and after it has been carried out, the bank's overall risk profile may be evaluated.

A thematic inspection focuses on selected activities of the bank, or the evaluation of a selected risk. A thematic inspection may also be carried out when approving the bank's internal models for the calculation of capital requirements.

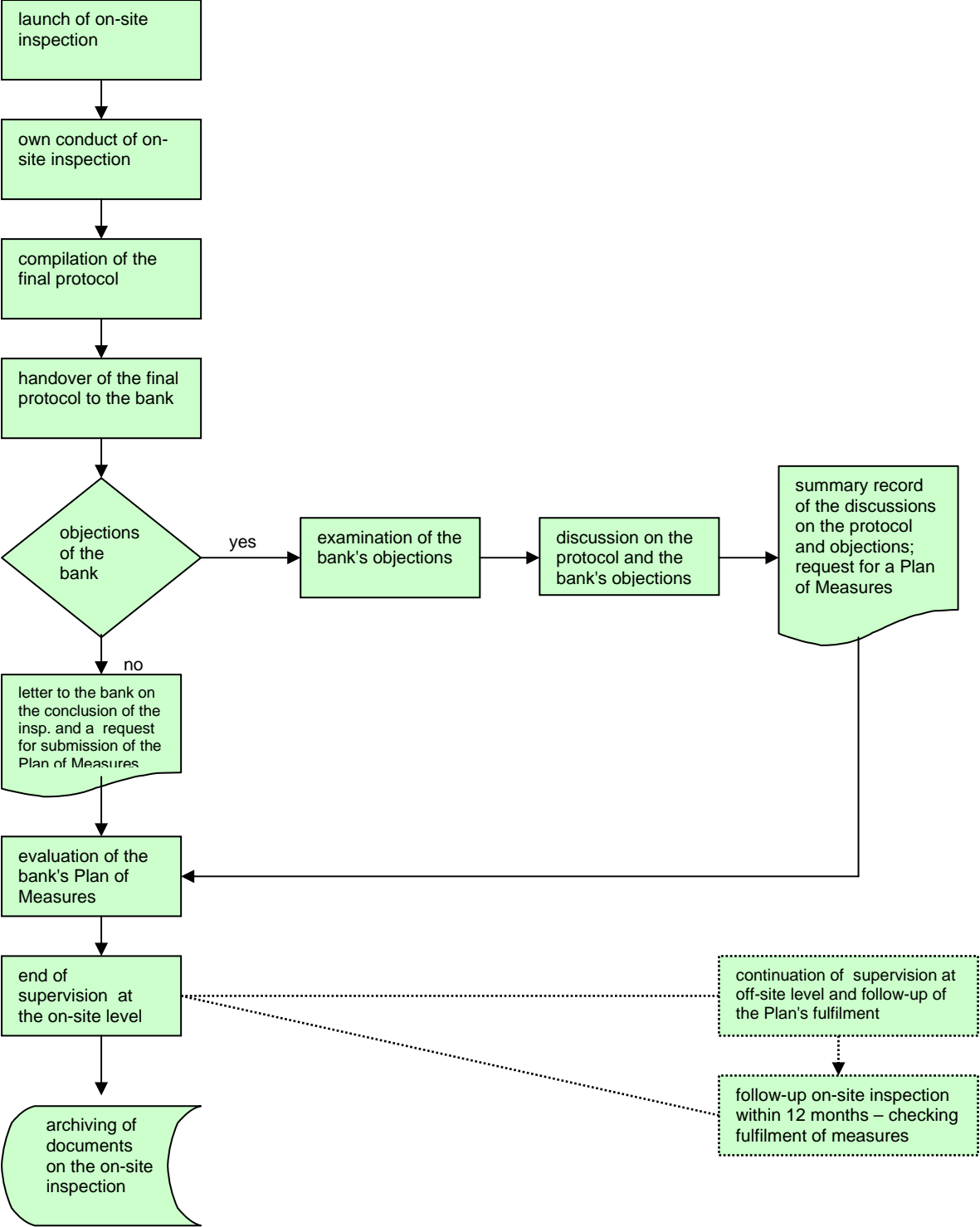
A follow-up inspection is aimed at evaluating the fulfilment of measures adopted by the bank on the basis of a comprehensive or thematic inspection. A follow-up inspection may be carried out simultaneously with a thematic or comprehensive inspection.

Following completion of the inspection, the on-site section is responsible for determining the bank's risk profile in the areas evaluated by on-site inspectors.

According to the nature and gravity of the findings, the on-site inspectors put forward proposals to the inspected bank, and especially proposals for actions to be taken vis-à-vis the bank in regard to rectifying the identified shortcomings and for a change in the inspection cycle.

The on-site section is responsible for conducting a follow-up inspection within 12 months after the completion of the on-site inspection, the objective being to evaluate the fulfilment of measures adopted by the bank for the removal of the shortcomings.

The course of an on-site inspection is shown in the scheme below.



**2.3 Procedures for the evaluation of a bank's risk profile**

Regarding the evaluation of banks through off-site supervision and on-site inspections, the different areas are covered by supervisory department procedures.

The procedures for inspecting banks and evaluating their risk profiles have the following structure:

Off-site supervision procedures

- Working procedure for off-site supervision

On-site supervision procedures

- General part
  - Preparation and conduct of on-site inspections
- Risk evaluation procedures
  - Credit risk
  - Market risk
  - Operational risk
  - Liquidity risk
  - Strategic risk
  - Reputation risk
- Procedures for assessing banks' activities
  - Credit transactions
  - Treasury transactions
  - Corporate governance
  - Internal control system
  - Information technologies and their security
  - Accounting and reporting
  - Anti-money laundering

### **3. Evaluating the Internal Capital Adequacy Assessment Process (ICAAP)**

The Supervisory Review and Evaluation Process also includes evaluating the bank's Internal Capital Adequacy Assessment Process (ICAAP). The supervisory authority is responsible for evaluating whether the bank has sufficient internal capital to cover its total exposure to material risks. In so doing, the supervisory authority will focus on whether the bank has identified all of its risk exposures, how the bank manages these risks and whether it takes into account the correlation between risks, and on evaluating the bank's management system.

When evaluating a bank's ICAAP, the National Bank of Slovakia takes into account the proportionality principle, in other words it considers differences between banks in terms of the size, nature, scale, and complexity of their activities. For the purposes of ICAAP evaluation, the supervisory authority categorizes banks into two groups. The first group comprises large banks as defined in part 1.1, and the second takes in building society savings banks and small and medium-sized banks. The supervisory authority expects members of the first group to employ more complex methods for the evaluation of internal capital adequacy, while members of the second group may simply use Pillar 1 methods along with the calculation and estimation of risks not covered in Pillar 1.

The selection of the methods used to evaluate internal capital adequacy relates also to the selection of methods which the bank will use to calculate capital requirements for credit, market and operational risks within Pillar 1. The qualitative requirements for the approval of advanced approaches under Pillar 1 include proving how the bank uses an advanced approach for the ICAAP. Banks employing advanced risk measurement methods under Pillar 1 are expected to use such methods also to evaluate their internal capital requirements. Banks using

advanced risk measurement methods under Pillar 1 will be expected to make appropriate use of them for the ICAAP.

How frequently a bank's ICAAP is evaluated will depend on the development of the risk profile, changes in the bank's strategy and products, and the bank's systemic importance. The ICAAP will usually be evaluated by an on-site inspection. The sequence of steps for the ICAAP evaluation will include requesting documents, holding meetings with representatives of the inspected bank, evaluating the documents and information that emerge from these meetings, and also utilizing other information acquired during the exercise of supervision.

Each tier of a bank's management has obligations and responsibilities laid down by laws, other legal regulations, and the bank's internal policies and procedures. The division of responsibilities will be taken into account by the supervisor when evaluating the ICAAP. Dialogue with the bank's representatives will be divided into at least two basic parts, namely:

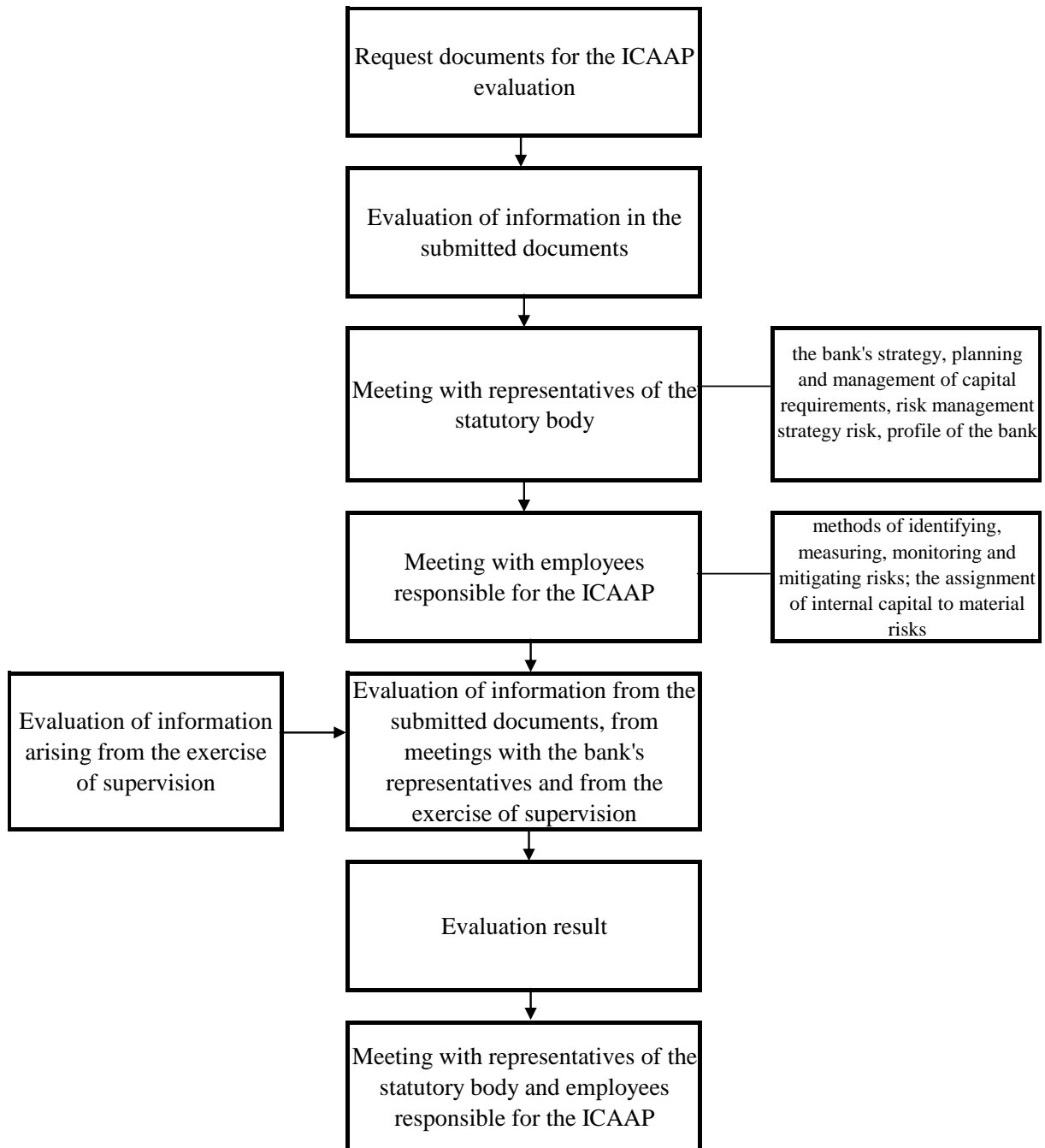
- a meeting with representatives of the statutory body;
- a meeting with employees responsible for the ICAAP.

The meeting with representatives of the statutory body will focus on issues relating to the bank's overall strategy, the planning of capital requirements, the manner of acquiring required capital, and the bank's risk management strategy, risk appetite and risk profile.

The meeting with employees responsible for the ICAAP will address more detailed issues concerning the identification, measurement, monitoring and mitigation of risks, and methods for calculating the resulting internal capital requirements.

After the evaluation of all information from the submitted documents and from the meetings with the bank's representatives, and of other information to emerge from the exercise of supervision, a follow-up meeting will be held with the bank's representatives, at which they will be informed of the results of the supervisor's evaluation of the ICAAP.

The scheme below shows the steps followed when evaluating the ICAAP.



#### 4. Supervisory measures

The National Bank of Slovakia imposes remedial actions on banks according to the nature and severity of the issues identified, in accordance with the provisions of Section 50 of Act no. 483/2001 Coll. on banks. The principle remedial actions include:

- ordering the adoption of recovery measures;
- ordering the submission of special statements, reports and disclosures;
- ordering the termination of unlicensed activities;
- imposing a fine;

- restricting or suspending the performance of certain banking activities or the performance of certain types of transaction;
- revoking the banking licence for certain banking activities;
- ordering the correction of accounting or other records in accordance with the findings of the National Bank of Slovakia or an auditor;
- ordering the publication of a correction of incomplete, incorrect or untrue information;
- ordering the settlement of business losses with registered capital, after retained earnings from previous years, funds created from profit, and capital funds have been used to settle the losses;
- introducing compulsory administration;
- revoking the banking licence;
- ordering the adoption of measures to improve risk management;
- requiring that the value of own funds are maintained at a level exceeding the capital requirements laid down by law;
- imposing special procedures to take account of the impairment of the bank's assets and expected losses on its off-balance-sheet items in order to meet capital requirements;
- ordering a reduction in significant risk undertaken by the bank in the course of its activities.