

BANKING AND FINANCIAL SUPERVISION
Supervisory Regulations and Policies Department

GUIDE TO SUPERVISORY ACTIVITIES

Circular 269 of 7 May 2008

PART 1

PRINCIPLES, OBJECTIVES, GENERAL METHODOLOGY

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SECTION I

SUPERVISORY OBJECTIVES, METHODOLOGIES AND EVALUATION PROCESS

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CHAPTER I

General outline

I.1 Foreword

This Guide to Supervisory Activities ("Guide") outlines the Supervisory Review and Evaluation Process ("SREP") and provides a common reference framework to those in charge of off-site as well as on-site supervision both in the Head Office and in the Branches of the Bank of Italy.

Given the complexity inherent in the supervision of intermediaries and the variety of structures and personnel tasked with it, as well as the way supervisory activities develop, this Guide is an organic point of reference suitable to guarantee behavioral consistency.

This Guide regulates all forms of control over intermediaries, with the exception of the initial authorization process and the crisis procedures.

Consistently with the general legal framework, the main goal of the assessment and control activities is to verify the supervised entities' sound and prudent management as well as their compliance with regulations ¹.

This Guide aims to make sure that this objective is pursued effectively and efficiently, in compliance with the transparency principle.

To this end, the procedures outlined in this Guide follow an approach:

- consolidated, to detect the intermediaries' overall risks and safeguards, regardless of their actual organizational and corporate structure;
- "risk-based", targeted at assessing all relevant risks and the corresponding organizational safeguards through the application of standard Analysis Schemes to intermediaries operating in the same field of activity, even when they are entered in different Registers;
- proportional, directed at grading controls in proportion to the intermediaries' size, systemic relevance and specific problems.

Procedures regarding the stages and basic checks of supervisory activities do not exhaust the detailed examinations that may be carried out in order to attain a full knowledge of intermediaries.

¹ This is without prejudice to the powers of CONSOB with regard to investment services and activities.

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I.2 Structure of this Guide

This Guide is structured in three Parts, each consisting of three Sections, whose main contents are described below.

Part 1 – “Principles, objectives, general methodology”

- Section I: principles and objectives of supervision; Supervisory Review and Evaluation Process (SREP); interaction mechanisms between offices tasked with supervision; Risk Assessment System (RAS); coordination with other supervisors.
- Section II: system for the organization and use of information in supervision; structure of the summary evaluation documents resulting from off-site and on-site controls.
- Section III: Analysis Schemes and assessment of risks (credit, market, operational and reputational, interest rate, liquidity, strategic) and of “cross-cutting profiles” (governance and control systems, profitability, capital adequacy) of intermediaries.

Part 2 – “Procedures for off-site monitoring”

- Section I: supervisory tools available for the dialogue with intermediaries (requests for information, invitations to meetings, inspections); intervention measures.
- Section II: criteria and procedures for the assessment of authorizations (on ownership structure, exogenous and endogenous growth plans, operations on supervisory capital, approval of mutual fund mandates).
- Section III: criteria and procedures for the assessment of authorization to use internal measurement systems for credit, market, counterparty, and operational risks for calculating capital requirements.

Part 3 – “Procedures for on-site inspections”

- Section I: guidelines for performing on-site inspections; duties and responsibilities of the members of inspection teams;
- Section II: administrative profiles of inspections; inspection procedure and presentation of results.
- Section III: procedures to be followed in inspections and Verification Patterns (VPs), differentiated according to risks, business areas, cross-cutting profiles or compliance issues.

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I.3 Scope

This Guide shows how to implement the SREP for all types of intermediaries ², including those subject to forms of prudential regulation different from the one based on the "Three Pillars" (capital requirements, supervisory review, disclosure) envisaged for banks, intermediaries regulated by Article 107 of the 1993 Banking Law ("Intermediaries 107") and some categories of investment firms ³.

Consistently with regulations, the SREP is carried out on the basis of an approach:

- **consolidated** ⁴:
 - for banking groups ⁵;
 - for those investment firms groups subject to consolidated supervision ⁶;
- **individual** with regard to the following entities, not belonging to banking groups or groups of investment firms subject to consolidated supervision:
 - banks ⁷;
 - investment firms ⁸;
 - asset management companies ⁹;
 - Intermediaries 107;
 - E-Money Institutions (EMIs);

² In this Guide the term "intermediary" refers to all entities subject to supervision, on the individual as well as the consolidated level.

³ In particular, prudential regulation based on the "Three Pillars" does not apply to: a) asset management companies; b) e-money institutions; c) intermediaries entered in the Register referred to in Article 106 of the 1993 Banking Law; d) investment firms exclusively allowed to provide one or more of the following services: i) investment consultancy and reception and transmission of orders without holding clients' money or securities; ii) investment services exclusively involving derivatives with a non-financial underlying (this exemption applies until 31 December 2010 only to investment firms working with qualified counterparties).

⁴ See Circular 263 of 27 December 2006 ("*New regulations for prudential supervision of banks*", henceforth "Circular 263") – Title I, Chapter 1, Part 2, Section III (supervision on a consolidated basis) and Regulation of 24 October 2007 concerning the prudential regulation for investment firms, Title IV, Chapter 3 (supervision on a consolidated basis).

⁵ Reference undertakings and the sub-consolidating members of the group as defined by Circular 263 are included.

⁶ That is: i) groups of investment firms including banks or investment firms authorized to deal for their own account or subscribe and/or place financial instruments with firm commitment underwriting or standby commitments to issuers; ii) groups of investment firms, other than those aforementioned, not exempted from consolidated supervision. Regulation on a consolidated basis does not apply in any case to the groups of investment firms consisting exclusively of investment firms only allowed to investment consultancy activity and/or reception and transmission of orders without holding clients' assets (see Regulation 24 Oct. 2007, Title IV, Chapter 3).

⁷ Including branches of non-EC banks and subsidiaries of foreign banks.

⁸ Including branches of non-EC investment firms.

⁹ In this Guide, the expression "asset management companies" refers also to open-end investment companies.

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- intermediaries entered in the General Register referred to in Article 106 of the 1993 Banking Law (“Intermediaries 106”).

This Guide specifies the tasks to be carried out at the individual level with regard to intermediaries belonging to groups subject to consolidated supervision.

The assessment of intermediaries belonging to groups that are not subject to consolidated supervision takes nevertheless into account the strategies of the group they belong to.

I.4 The classification of intermediaries

The SREP implies the prior gathering of the structural and operational characteristics of each intermediary (“classification”).

The classification allows to:

- 1) position intermediaries within one of the five regulatory macro-categories, in order to apply the proportionality principle;
- 2) identify the “relevant entities” of groups subject to consolidated assessment;
- 3) define homogeneous sets of intermediaries on the grounds of their predominant activity so as to set up peer groups or apply standardised Analysis Schemes.

As to point 3), classification is needed to identify “specialized” intermediaries as well as their predominant activity. For non-specialized intermediaries, peer groups are defined on the grounds of size as well as institutional criteria ¹⁰.

The predominant activity is identified in accordance with the scheme set in Table 1, which makes a distinction between two levels: the first corresponds to four macro-activities (lending, investment services, asset management and other activities); the second identifies more detailed levels of specialization.

¹⁰ Only size is taken into account on a consolidated basis (groups).

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Table 1 – Classification of predominant activities

ACTIVITY	
Credit activities	Level I
<i>Leasing</i>	Level II
<i>Factoring</i>	
<i>Consumer credit and personal loans</i>	
<i>Loans backed by 1/5 of salary</i>	
<i>Mortgage loans</i>	
<i>Other loans</i>	
Services and investment activities	Level I
<i>Dealing for own account</i>	Level II
<i>Execution of orders for clients (including the collection of orders)</i>	
<i>Placement of financial instruments</i>	
<i>Management of investment portfolios</i>	
<i>Management of multilateral trading facilities</i>	Level II
Collective portfolio management	
<i>Management of non-speculative open-end funds</i>	
<i>Management of closed-end securities funds</i>	
<i>Management of closed-end real estate funds</i>	Level II
<i>Management of hedge funds ¹¹</i>	
Other activities	
<i>Issue of guarantees</i>	
<i>Confidi (i.e. entities engaging in the provision of collective guarantees for loans, using resources received entirely or in part from the member undertakings for the mutual and entrepreneurial provision of guarantees in order to facilitate the granting of loans by banks and other persons operating in the financial sector)</i>	Level II
<i>Management of problem assets</i>	
<i>Issuing and managing credit cards</i>	
<i>Servicing in securitizations</i>	
<i>Acquisition of holdings</i>	
<i>Management of pension funds</i>	

The classification is carried out automatically by means of software tools utilizing the supervisory database. Analysts ¹² may add informative elements (such as recent business changes) that automated programs are unable to take into consideration.

¹¹ Asset management companies operating closed-end hedge funds oriented towards private equity and real estate are included amongst those specialized, respectively, in the management of closed-end securities or real estate funds.

¹² Henceforth, the term “analyst(s)” will refer to the person(s) in charge of off-site monitoring.

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I.5 Proportionality and macro-categories

Prudential regulations, also with a view to cost containment for intermediaries, provides that obligations imposed on supervised entities be graded according to their characteristics, size and complexity (proportionality principle).

Such principle finds symmetric application in control activities. Here, the systemic impact and the intermediaries' weaknesses are particularly relevant.

In order to give application to the proportionality principle, intermediaries are divided into five macro-categories (see Table 2):

1. "Intermediaries having a significant international presence";
2. "Nationwide systemically-relevant intermediaries": entities – including those controlled by foreign-based intermediaries – with total assets of no less than 20 billion euro and, conventionally, other intermediaries, other than those referred to in point 1, which are allowed to use internal risk-measurement systems for calculating capital requirements (intermediaries with "authorized systems");
3. "Medium-large intermediaries": entities – not falling within macro-categories 1 and 2 – characterized by at least one of the following conditions:
 - total assets between 3.5 and 20 billion euro (banks and Intermediaries 107);
 - assets under management exceeding 10 billion euro (intermediaries mainly involved in asset management);
 - annual turnover – dealing for own account or for the account of a third party – exceeding 150 billion euro (intermediaries mainly involved in dealing for own account or for the account of a third party);
4. "Minor intermediaries": entities characterized by at least one of the following conditions:
 - total assets of 3.5 billion euro or less (banks, mainly mutual banks, and Intermediaries 107);
 - assets under management of 10 billion euro or less (intermediaries mainly active in asset management);
 - annual turnover – dealing for own account or the account of a third party – of 150 billion euro or less (intermediaries mostly involved in dealing for own account or for the account of a third party);

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5. Entities subject to specific regulations ¹³.

Table 2 – The “macro-categories”

1.	<u>Intermediaries having a significant international presence</u> : intermediaries controlling foreign subsidiary banks whose business constitutes a significant share of the banking group; some of Class 1 ICAAP intermediaries converge in this macro-category.
2.	<u>Nationwide systemically-relevant intermediaries</u> : intermediaries operating domestically and taking systemic relevance for the banking and financial markets; such groups may be present abroad, although such presence does not represent one of the cases of macro-category 1. Class 1 and Class 2 ICAAP intermediaries converge in this macro-category.
3.	<u>Medium-large intermediaries</u> : medium-sized intermediaries mainly operating at a regional level. Also included are larger specialized intermediaries (management companies, investment firms, Intermediaries 107 and banks operating in specific market segments). Class 2 ICAAP intermediaries not included within macro-category 2 converge in this macro-category.
4.	<u>Minor intermediaries</u> : intermediaries operating primarily at a provincial and inter-provincial level. Smaller specialized intermediaries are also included. The intermediaries of this kind fall within Class 3 ICAAP.
5.	<u>Entities subject to specific regulation</u> : intermediaries, other than management companies, which are not subject to prudential regulation based on the "Three Pillars" (EMIs, Intermediaries 106 and certain types of investment firms).

The “macro-categories” are consistent with the ICAAP classes provided in the prudential regulation, as shown in Table 3.

Table 3 – ICAAP classes and macro-categories

MACRO-CATEGORIES	I C A A P CLASSES		
	1	2	3
1. Intermediaries having a significant international presence	X		
2. Nationwide systemically-relevant intermediaries	X	X	
3. Medium-large intermediaries		X	
4. Minor intermediaries			X
5. Entities subject to specific regulation	ICAAP NOT APPLIED		

The criteria outlined in this Guide to enforce the proportionality principle constitute general guidelines for analysts who may, by virtue of their direct

¹³ EMIs, Intermediaries 106, investment firms mentioned in footnote 3 all fall within this category. Although subject to prudential rules different from those based on the "Three Pillars", asset management companies are distributed, with a view to analysis, between macro-categories 3 and 4 depending on size.

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knowledge of intermediaries, determine the appropriate extent and depth of analysis with regard to the information available, the past dynamics of technical variables, the business climate, both general and sectoral, and the development of the markets of reference.

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CHAPTER II

The Supervisory Review and Evaluation Process (SREP)

II.1 General features

II.1.1 Process phases

Under prudential regulation, the Supervisory Review and Evaluation Process (SREP) aims to check whether intermediaries have appropriate capital and organisational safeguards vis-à-vis the risks they take, ensuring an overall operational balance.

The SREP comprises a set of actions which allow to evaluate the current and future situation of intermediaries and, in the presence of significant deficiencies and/or anomalies, lead to the adoption of appropriate corrective measures.

SREP is structured in two phases:

- A. evaluation cycle (periodic);
- B. correction/follow-up (contingent).

A. Evaluation cycle

The “evaluation cycle” consists of three steps: planning (a), control and analysis (b), evaluation (c).

a) Planning aims to identify:

- the scope of evaluation: risk profiles, business lines, legal entities to be assessed;
- the instruments to be used: off-site assessments, meetings with corporate officers, on-site inspections;
- the time references for the “evaluation cycle” and the timing of the analysis to be performed.

b) The control and analysis activities include:

1) checking compliance with regulation concerning:

- prudential rules and operational limits;
- financial statements;
- disclosure requirements;

2) the analysis of the intermediary’s situation with regard to:

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- the ICAAP process (where required by the applicable regulation) for calculating the total capital the intermediary deems adequate to cover its risks;
 - the exposure to all relevant risks and the corresponding organisational safeguards, by means of the RAS; in this regard, checking the maintenance over time of the requirements for authorization to use the internal risk measurement systems for calculating capital requirements becomes relevant.
- c) The evaluation consists in attributing scores to the risk areas and the cross-cutting profiles covered by the RAS, then forming the total score of the intermediary.

B. Correction/follow-up phase

As a result of the evaluation cycle, the corrective measures are determined, where necessary, tailored in accordance with the type and severity of the anomalies found.

The corrective actions are normally communicated to the intermediary in a letter setting the implementation deadline for the requested actions and explaining the procedures for reporting on the results.

Supervisory measures – discussed in detail in Part 2 of this Guide – are consistent with the results of the analysis of risks and of the intermediary's overall situation (principle of correspondence between evaluation and action), as well as the level of awareness and reliability of corporate officers.

In the follow-up phase, progress in the implementation of the plan defined by the intermediary to meet the requests of the supervisor is monitored, taking into account the intermediary's operational specializations and its general situation.

II.1.2 Analysis Schemes – Risk Assessment System

Analysis methodologies and evaluation standards are defined in the RAS, that is the main SREP instrument. It allows to assess risk exposures and adequacy of the pertinent controls, as well as the organisational, capital and economic safeguards, in order to be able to form an overall opinion.

The RAS describes a structured survey procedure in which off-site and on-site controls are performed in an integrated way, with a logic aimed at adopting the most appropriate instruments to attain the desired results.

Based on specific Analysis Schemes, the following issues are subject to evaluation:

- a) Risk areas:
- strategic risk

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- credit risk
- market risk (including counterparty risk)
- liquidity risk
- interest rate risk
- operational and reputational risk

b) Cross-cutting profiles:

- governance and control systems
- profitability
- capital adequacy

The judgment expressed derives from:

a) with regard to risk areas, the combination of the evaluations given to:

- risk exposure (quantitative aspect);
- adequacy of specific organisational arrangements (qualitative aspect);

b) as for cross-cutting profiles, a qualitative analysis of governance and controls and a quantitative analysis of profitability and capital adequacy.

Risk exposure, profit and capital adequacy are assessed on the basis of Analysis Schemes, that are mainly fuelled by prudential returns and generate an “automatic” score; this can be adjusted using the “integrative schemes”.

The Analysis Schemes are uniformly applied, in both off-site and on-site controls, where risk exposures are re-calculated only if adjustments emerging from on-site verifications require a modification of the judgment.

The organisational evaluations are based on an interpretation process of “qualitative” factors. The indications given in this respect by the Analysis Schemes in this Part of the Guide refer essentially to off-site controls. More detailed information – which can be used principally during inspections – can be found in the Analysis Patterns (see Part 3 of this Guide), which are consistent, as regards interpretation logic and evaluation criteria, with the Analysis Schemes.

II.1.3 Frequency of controls

The evaluation cycle usually has an annual frequency.

In case of entities with high operational complexity the evaluation cycle may be longer, to be determined also considering the distribution of tasks

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in the colleges of supervisors and the time necessary for the foreign supervisory authorities to perform their respective duties.

In case the evaluation cycle is longer than 12 months, on an annual basis it will be necessary to: a) assess the exposure to risks and the cross-cutting quantitative profiles by analysing the scores automatically generated by the models and the integrative schemes, which can determine adjustments to those scores; b) check compliance with the regulation concerning financial statements and disclosure requirements; c) examine the ICAAP.

For all intermediaries it is necessary to:

- check compliance with prudential regulation and operational limits with the frequency of the relevant prudential returns;
- check profitability, capital adequacy and risk exposure half-yearly;
- evaluate the risk profiles more frequently than annually or half-yearly in case of significantly unfavourable developments ¹.

II.1.4 Off-site analysis

Off-site supervision aims to constantly monitor the intermediaries' situation as well as give early warnings on a deterioration of the significant risk profiles, so as to timely promote the most appropriate corrective measures.

According to the proportionality principle and with an eye to integration with on-site controls, the off-site analysis has to:

- check the intermediaries' constant compliance with prudential regulation and operational limits;
- proactively monitor the evolution of the financial situation;
- control the effectiveness of actions taken by the corporate officers to eliminate the shortcomings found;
- update, if necessary, the information resulting from on-site inspections, in particular with reference to corporate governance and quality of organisational arrangements.

Off-site controls are systematic, carried out at set intervals, based on analysis of data and information that intermediaries have to report regularly or upon specific requests.

The assessments, inspired by prudence, must be coherent with the information available, whose reliability has to be subject to an appropriate critical verification. This is especially relevant with reference to off-site analysis of "qualitative" aspects and, in particular, of the organisational arrangements to manage risks and of governance and control systems.

¹ As regards liquidity risk, experience shows that, in case of serious market turmoil, daily monitoring may be necessary by requesting specific and non-standard data and information. Where intermediation of financial derivatives increases significantly in a relatively short period of time, a considerable counterparty risk exposure may arise which, sometimes, the intermediary may not be fully aware of.

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Information collected by the off-site analysis teams during meetings with the corporate officers must be weighed with the same attention ².

In those cases, qualitative evaluations have a limited value in determining the global score and those for individual profiles (see the RAS “evaluation grid”).

Conversely, availability of accurate analyses and validations from recent inspections and/or information on intermediaries with “authorized systems” allow to give reliable qualitative evaluations, fully valid when awarding the overall score and those for individual profiles.

Controls and analyses are performed using the SIGMA procedure.

II.1.5 Inspection analysis

On-site supervision – discussed in more detail in Part 3 – is directed at analyzing and assessing the situation of the supervised entities and of cross-cutting and risk profiles to allow, among other things and if necessary, the prompt adoption of appropriate corrective measures.

According to current regulation, inspections may concern:

- the intermediary's overall situation (full-scope inspections);
- business areas, risks, operational profiles (targeted inspections);
- progress in implementing the corrective measures adopted autonomously by intermediaries or upon request by the supervisor (follow-up inspections);
- general aspects concerning the overall banking and financial system (targeted inspections).

In compliance with the proportionality and risk focusing principles and in view of complementing the off-site analysis, inspections essentially aim at checking:

- the exposure to significant risks and the corresponding organisational arrangements;
- the adequacy of structural and functional components of governance and control systems as well as economic and capital safeguards;
- the reliability of data and information given to the Supervision;
- the compliance with the regulatory framework with particular attention to prudential requirements.

² Any dialogue/discussion held at the intermediary's premises – upon invitation by the latter – by off-site analysts with operational managers, to delve into specific regulatory and/or applicative issues are not considered inspections under the legislation in force and therefore do not entail for the Supervision the typical responsibility of inspections. These (usually short) talks are not aimed at checking information or communicating evaluations to the entity concerned.

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Inspections determine the attribution of scores to intermediaries according to the RAS. In particular, inspective evaluations stem from:

- standardized models of risk quantification, also adopted for off-site controls, after making any necessary adjustments to the related data in light of the assessment of the corresponding activity;
- in-depth analysis of the intermediaries' governance, organisational and control processes and structures.

Normally, inspections are carried out on the basis of a blueprint that takes into account all the needs emerged from the SREP.

Consistently with their objectives and the type of controls involved, inspection mandates may include access to specific operational areas and to one or more intermediaries, either independent or belonging to a group.

Inspections are carried out by means of the "Verification Patterns" (VPs) illustrated in Part 3 of this Guide, designed according to modularity criteria. VPs are articulated in areas of verification coherent with the approach followed by the RAS and with the typical characteristics of intermediaries.

Results are shown in the inspection report, whose contents respond to the information requirements indicated in the mandate.

II.1.6 The dialogue with intermediaries

The supervisory activity is ordinarily performed by means of a dialogue with intermediaries, based on exchanging information and aimed at facilitating the analysis of risk exposures, organization and the self-evaluation process of capital adequacy (ICAAP).

The dialogue is carried out steadily during inspections; in off-site supervision its frequency and intensity vary according to the proportionality principle and consists of documentation requests and meetings with corporate officers. Meetings³ – based on Article 53, paragraph 3 of the 1993 Banking Law and Article 7, paragraph 1 of the Consolidated Law on Finance – are occasions for focused discussions, particularly useful for a full understanding of corporate choices.

A full co-operation by corporate officers allows analysis and evaluations based on reliable information, increases the amount of information available to the Supervision, eases the dialogue with the intermediaries, improves the understanding of any corrective actions required.

Even if extensive and intense, the dialogue must be based on a clear distinction of roles and be performed with a view to safeguarding the autonomy and independence of corporate officers, who have full responsibility with regard to the intermediaries' governance.

³ The meetings take place at the Bank of Italy's premises. Information so obtained is recorded in specific reports by the competent units.

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Intermediaries must facilitate the supervisory analysis. Full understanding of strategies, operations and relevant risks – which is an essential element of risk-based supervision – requires in fact flexible contacts with the intermediaries, coherent with their characteristics.

The Supervision's counterparty for each phase of the dialogue must be carefully identified: objectives to be attained, organization of the intermediary, complexity of the issues to be analyzed are the key points.

The interaction with the supervised entities plays a rather significant role with respect to:

- examining the ICAAP report, with the assistance of the competent corporate functions (e.g. on methodologies, risk aggregation, quality of organization);
- implementing any measures consequent to the SREP;
- authorizing the use of internal risk measurement systems for calculating capital requirements, the complexity of which requires an extensive and structured interaction with the intermediary, especially with the control functions. Given the relevance and impact on management that the adoption of such systems for prudential purposes has, the results of that interaction must reach the top levels of the entity's hierarchy, even in the phase preceding the application for authorization (“pre-validation”);
- the evaluation of asset management companies. As these are not included in the so-called Second Pillar, they neither perform the self-evaluation process nor submit the ICAAP report. Meetings are therefore the occasion for integrating the available information.

When selecting the necessary instruments (e.g. request for supplementary documentation, meetings, inspections) among many equivalent in effectiveness, those minimizing the burden for the supervised entity must be chosen.

Clear communication with the intermediaries is essential for the success of the dialogue; it is necessary that the matter and the objective of the information and clarification requests are adequately illustrated.

II.2 The “Evaluation Cycle”: assessing compliance with regulatory requirements

II.2.1 Frequency and general remarks

An effective supervisory action requires a regular assessment of the intermediaries' compliance with prudential rules and the other regulatory requirements.

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Such an assessment concerns: regulatory capital; compliance with regulations on: capital requirements, large exposures, limits to shareholdings and to real estate investments; financial statements; disclosure. Specific controls are envisaged for some categories of intermediaries.

The control activity on compliance with prudential rules and other operational limits has to be performed with the following frequency:

- semi-annually (end-June and end-December) on a consolidated level (except for the quarterly review of compliance with large exposure regulation);
- quarterly (end of March, June, September and December) on an individual level both for intermediaries that are part of a group and for independent ones;
- monthly, for investment firms dealing for own account and/or providing placement with stand-by commitment to issuers.

In the following paragraphs, the envisaged controls are illustrated, with some indications to be followed for their performance. Increased attention shall be paid whenever the intermediary:

- has a very limited excess capital above the regulatory limit (indicatively no more than 10 per cent of the requirement or of the minimum level);
- has had, over time, a significant and progressive reduction of that excess.

In such cases, the depth of controls must be increased and – when analyzing risks – the causes of the detected trends shall be sought, in order to ascertain the possibility of future deviations. The same applies when the intermediary has submitted a recovery plan for one of the prudential profiles, to check the fulfillment of the targets set out in the plan.

Controls are performed as soon as the pertinent returns are available, to avoid losing efficacy of action and to intervene timely in case of deviations.

The other checks (e.g. on financial statements, on disclosure) are performed on an annual basis.

II.2.2 Regulatory capital and capital requirements

Given the central position of regulatory capital as the yardstick for all prudential requirements, its evolution and composition should be accurately controlled. Special attention also needs to be placed on the evaluation of end-June and end-December statements, as the corresponding regulatory capital includes the profit for the first semester and the whole financial year, respectively ⁴.

⁴ Except for investment firms and asset management companies, whose profits have an impact on prudential capital only after the final approval of the financial statements.

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The correspondence with the financial statements shall be ascertained first and, to the largest possible extent, their exactness, asking the intermediary for any necessary clarification.

Compliance with capital requirements set out in prudential regulation shall also be checked, as well as their trend and composition.

II.2.3 Large exposures

Compliance with regulatory limits on credit risk concentration shall be verified first. The controls concern the trend of large exposures in relation to the supervisory capital with reference to both their total weighted amount (global limit) and the exposures towards individual counterparties (individual limit).

Special attention shall also be given to:

- the quality of large exposures, verifying the ratio between any amount reported among bad debts, the total exposure and capital, collecting information internally (inspection reports, comparisons of classification methods used by different intermediaries) and from external sources, that may be relevant for evaluating any insolvency risks on these positions;
- the composition of large exposures, as limits are referred to risks of all kinds with the same counterparty;
- the assessment of any legal and/or economic connections between clients in case the information available indicates the opportunity of further controls;
- the risk positions with counterparties that, directly or indirectly, may influence the intermediary's management, as well as persons connected to those counterparties (see Article 53, paragraph 4 of the 1993 Banking Law).

II.2.4 Limits to shareholdings

Controls aim to verify compliance with provisions on shareholdings applicable to the different categories of intermediaries.

In particular, for all types of supervised entities (except for the Intermediaries 107) the general limit to shareholdings set forth in the respective regulations shall be checked ⁵.

The following limits to shareholdings are also to be checked:

⁵ Total shareholdings must be limited within:

- the amount of regulatory capital, for independent banks and banking groups, also taking into account investments in real estate;
- the adjusted Tier 2 capital for investment firms;
- 50% of regulatory capital for asset management companies (excluding shareholdings already deducted from regulatory capital).

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- for **banks and banking groups**, shareholdings in: (i) insurance companies (global limit); (ii) non-financial firms (global limit, concentration limit and segregation limit);
- for **investment firms**, non-financial shareholdings (segregation limit).

As regards other intermediaries, **asset management companies** cannot acquire shareholdings in entities operating in non-financial sectors; **electronic money institutions** can only take shareholdings in entities performing collection or funds transfer or servicing on means of payment issued by third parties.

In case of shareholdings acquired in debt collection, it needs to be verified that any excess above the global, concentration and segregation limits be reported as a capital requirement to be added to the other capital requirements.

II.2.5 Limits to real estate holdings

As regards real estate holdings, compliance with the following rules has to be checked:

- **banks and banking groups** can only acquire and hold instrumental real estate⁶. Real estate investments and shareholdings cannot exceed supervisory capital. This limit can be exceeded only for real estate acquired in debt collection; in this case, the excess amount is a capital requirement to be added when calculating the total requirement. Real estate acquired in debt collection is to be re-sold as soon as possible, given the objective of such transactions; **investment firms** not belonging to a banking group shall classify real estate – except those guaranteeing loans – as non-negotiable assets, as such to be deducted from regulatory capital;
- real estate of **asset management companies** and **Intermediaries** **107**⁷ can only be instrumental to their financial activity.

II.2.6 Examining the financial statements

The official annual financial statements are an important source of information in the SREP. They are also subject to examination in relation to the powers, given to the Bank of Italy, concerning their technical form.

The verification activity on the quality of financial statements must be performed by the subjects legally responsible for ensuring their compliance to the rules: the competent officer, the auditors and/or the control body. It is

⁶ These are buildings auxiliary or instrumental to the banking activity (including buildings acquired in debt collection), or to the corporate purposes of the owner that is part of the banking group.

⁷ See Circular 216 of 5 August 1996 ("Prudential Regulation for Financial Intermediaries registered in the Special Register"; from now on, "Circular 216") — Part I, Chapter 3 which, among other things, for premises acquired in debt collection stipulates a regulation equivalent to that laid down for banks.

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therefore correct to assume, in principle, that the financial statements are exhaustive and correctly drafted.

Having said that, the assessment of the financial statements is performed jointly and in an integrated fashion with the analysis of risks; in particular, the examination of financial statements is useful for:

- a better understanding of the technical situation of intermediaries, in particular with regard to the information on the fundamental aggregates for supervisory purposes (capital, default exposures, large exposures, etc.);
- identifying possible transactions or operational situations requiring a more in-depth analysis when describing the supervisory evaluation of intermediaries.

When significant mistakes, missing information in the accounting records or considerably-different data with respect to the official prudential returns are found, intermediaries are asked to clarify the situation. When necessary, the start of a sanction procedure needs to be considered.

When verifications show significant problems, the supervisory action has to be adjusted according to the possible procedural indications that, time by time, the Financial Statements and Prudential Returns Division of the Supervisory Regulations and Policies Department may provide.

Analysts examine the individual and consolidated financial statements through the specific procedure available in the SIGMA system. The reference criteria for banks and banking groups can be found in the "Verification Procedures of Banks' Financial Statements" manual⁸.

In agreement with the Heads of the competent Bank of Italy's Branches or Departments, the Heads of the Supervision Units determine every year how these duties are to be performed, also considering the current availability of human resources.

II.2.7 Disclosure requirements check

In conformity with prudential regulation (i.e. the "Third Pillar")⁹, the verifications on public disclosure requirements are carried out as follows:

- verification of the existence of organizational arrangements ensuring a reliable preparation, processing and disclosure of information; this activity – to be mainly performed during inspections – entails the evaluation of the independence and qualification of the function in charge of controls¹⁰;

⁸ See message n. 602139 of 14.06.2007 of the Methods and Procedures Division and its regular updates.

⁹ See Title IV, Chapter 1 of Circular 263 and Title III, Chapter 1 of Regulation of 24.10.2007.

¹⁰ With respect to independence and professional standards, the following factors need to be considered: a) the attribution of a specific responsibility for controlling the process for the preparation, data processing and disclosure of information; b) the separation of responsibility between those in charge of

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- examination of the public disclosures envisaged in the prudential regulation, performed together with the analysis of financial statements, including those necessary for the use of internal risk measurement systems for calculating capital requirements and risk mitigation.

II.2.8 Specific controls for particular categories of intermediaries

With reference to particular categories of intermediaries, specific controls need to be performed; namely:

- for **mutual banks**, regulatory limits to operations with non-member entities or entities outside the territory of competence, limits to shareholdings, foreign exchange and activity in derivatives need to be checked;
- when checking the activities of **asset management companies**, the regulatory limits to UCITS investments (see Title V, Chapter III of the Bank of Italy's Regulation of 14 April 2005) need to be checked. The verifications are aimed at assessing compliance with prohibitions and limits on risk limitation and concentration applying to "harmonized" and "non-harmonized" open-ended funds, by processing the data included in the prudential returns or the reports of the asset management companies and the depository banks. For closed-ended funds not restricted to qualified investors, the purchase by the asset management company of a share of the net total value of the fund and its subsequent issues needs to be verified (the amount to be purchased is set in the Regulation of 14 April 2005).

II.3 The "evaluation cycle": analysis of risks and safeguards

II.3.1 The ICAAP examination

The ICAAP examination (i.e. the self-evaluation process of capital adequacy performed by the intermediaries themselves) is an important phase of the supervisory review and assessment process.

This entails the examination of a series of closely related elements, both of quantitative and qualitative nature. From a theoretical point of view, they can be split into two categories:

- a) modellistic-methodological aspects, concerning specifically:
- the measurement of the internal capital with respect to each category of significant risk taken by the intermediary;
 - the calculation of the total internal capital;

data preparation and those in charge of controls; c) the adequacy of technical and human resources dedicated to the control activity.

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- the reconciliation of the total internal capital and the regulatory requirements, and of the total capital and the regulatory capital;
- b) administrative and organisational aspects with reference to two main evaluation elements:
 - the capital planning process;
 - risk management ¹¹ and control.

In the RAS, the in-depth study of the aspects under a) above contributes to the evaluation of each risk profile and is an essential element in assessing the capital profile, which ultimately aims to judge the present and future capital adequacy.

Analyzing management and organizational aspects (point "b" above) helps to evaluate both the governance and the control systems (specifically concerning the capital planning process) and the single risk profiles (as regards the relevant organisational safeguards).

Those elements of analysis and assessment are to be found in the "ICAAP Report", which includes all the structural information that the intermediary has to report yearly to the Supervision ¹².

The large amount of information obtainable from that Report – of a descriptive nature and with a self-evaluation purpose – must be subject to a comprehensive critical review, also in the light of the RAS results, to weigh the opportunity of a prompt discussion with the intermediaries to detect the key problems. The intermediaries, in turn, must identify those areas in the process which need improvements, as well as plan the consequent actions on capital and/or organization.

Especially for the most complex intermediaries, the ICAAP examination is carried out using both off-site instruments and inspections tools.

The off-site information allows to proceed with an assessment of the whole structural design of the ICAAP process and, in particular, of its quantitative and methodological aspects in order to measure the capital adequacy of the intermediaries, especially with reference to any gaps between "regulatory" and "internal" risk and capital measurements as described by the intermediaries themselves.

The on-site activity allows to accurately examine the qualitative aspects: on the one hand, to correctly evaluate the real efficacy of the organization and governance profiles related to the ICAAP process; on the other, to check the effective integration of this process within the corporate decisions (i.e. the "use test"). Furthermore, inspections allow to confirm the quality of the databases supporting the measurements related to the ICAAP.

¹¹ In this context, "risk management" includes the identification and measurement phases.

¹² For a detailed description of the ICAAP Report, see Title III of Circular 263 (Appendix E) and Title II of the Regulation of 24.10.2007 (Appendix B).

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II.3.2 Risk analysis and overall evaluation of the intermediary

The evaluation of the main risks taken by the intermediary and of the organizational, economic and capital arrangements adopted is the crucial step of the supervisory activity and evaluation process.

Analysis and evaluation are performed considering all the information available and making use of the procedures, schemes and methodological standards provided by the RAS.

In line with the risk-based approach, the analysis is focused on the risks taken by the intermediary, assessed against both the level exposure and the organizational safeguards set for governing, managing and controlling them.

The evaluation given to the whole situation, to risk areas and to cross-cutting profiles is summarized by scores/judgments, with respect to the level of risk exposure and to the degree of adequacy of organizational and economic/capital arrangements.

This phase of the evaluation cycle should usually end by the **31 July** following the year of reference. The half-yearly integrations should normally be concluded by the **31 December** following the semester of reference¹³. These deadlines are indicative, depending on the resources available.

II.4 The “evaluation cycle”: attributing Profile and Total Scores

The attribution of Profile (A) and Total Scores (B) follows the same dynamics in both off-site controls and inspections.

A) Profile Scores

Profile scores – on a 1 to 6 scale, where the highest score indicates the worst evaluation – are awarded following the criteria illustrated in the specific Analysis Schemes.

For credit, market, interest rate and liquidity risks, where both quantitative and qualitative evaluations are used, a distinction needs to be made between the following scenarios:

- a) when “exhaustive”¹⁴ information is available, the analyst can assign a full-scale Profile Score (from 1 to 6) to the qualitative component, attributing to it the same weight as the one given to the quantitative component; if, on the contrary, the analyst considers one of the two

¹³ Accordingly, the other activities – illustrated in the previous paragraphs – propaedeutic to risk analysis and overall evaluation must be completed by the same deadlines.

¹⁴ Significant and confirmed information deriving, for example, from: recent inspections; verifications on the internal systems for calculating capital requirements; detailed negative reports from corporate officers.

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components as prevalent, appropriate weights shall be used. Qualitative valuations made during inspections are to be considered “robust” and determine a full-scale judgment;

- b) lacking the conditions described under a) above, but with sufficient information available, when awarding the profile score the analyst can rectify the quantitative judgment by one point (“notching”) ¹⁵.

For strategic, operational and reputational risks, where both quantitative and qualitative evaluations are found, the specific standards described in the relevant Analysis Schemes apply.

To avoid a proliferation of sub-scores on the above-mentioned risk profiles, only one profile score is to be assigned.

The entire qualitative and quantitative evaluation process must be fully performed anyway. The logical steps and the reasons underlying the assessments need to be clarified whenever the Profile Score:

- a) differs from the automatic score;
- b) does not differ only because of adjustments in the intermediate steps (analysis of Integrative Schemes, assessment of qualitative components).

To simplify and increase the efficiency of the evaluation, the scores on the following profiles shall be combined:

- market, counterparty, interest rate and liquidity risk (“financial risks”);
- strategic risk, governance and control systems.

The contribution of each individual profile to the combined one is proportional to the relevance given to it by the analyst or inspector ¹⁶.

The assessment flow described above is summarized in the following scheme:

¹⁵ Special attention must be given to the relevance of information used when the correction implies the transition from positive (1-3) to negative (4-6) scores or vice versa (see the scale described under “B” in this paragraph).

¹⁶ For example, for financial risks the scores given to each of the three profiles assessed (market and counterparty, interest rate, liquidity) have to be evenly weighted (33.3%) whenever a preeminent relevance of any of them is not found: e.g. if the dealing business is significant for an intermediary, the pertinent score should be weighted 50%, giving the other two a 25% weight. Vice versa, for banks inactive in dealing for own account, only the liquidity and interest rate profiles are assessed.

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Table 1

ASSESSMENT FLOW		A	B			
		Quantitative assessment	Qualitative assessment		SUMMARY	
			"Sufficient" information	"Robust" information	"Sufficient" qualitative information	"Robust" qualitative information
a	STRATEGIC RISK AND GOVERNANCE AND CONTROL SYSTEMS					
b	CREDIT RISK	1-6	2-5	1-6	B	B
c	FINANCIAL RISKS (market, counterparty, interest rate, liquidity)	1-6	+/-1	1-6	A+B	average (A:B)
d	OPERATIONAL AND REPUTATIONAL RISKS	1-6	+/-1	1-6	A+B	average (A:B)
e	PROFITABILITY	1-6	2-5	1-6	average (A:B)	average (A:B)
f	CAPITAL ADEQUACY	1-6			A	A

The quantitative evaluation, an indicator of the level of exposure to risk, is stated according to the following scale: very low=1; low=2; medium-low=3; medium-high=4; high=5; very high=6.

The adequacy of the "profitability" and "capital adequacy" cross-cutting profiles is indicated by their quantitative evaluation (very high=1; high=2; medium-high=3; medium-low=4; low=5; very low=6).

The qualitative evaluation is stated according to the following scale: excellent=1; good=2; sufficient=3; poor=4; insufficient=5; bad=6.

B) Total Score

The Total Score falls in a 1 to 6 scale, where the highest score indicates the worst assessment, as follows:

- | |
|--|
| 1 = Good
2 = Satisfactory
3 = Broadly satisfactory
4 = Broadly unsatisfactory
5 = Unsatisfactory
6 = Weak |
|--|

The Total Score is assigned by the analyst or inspector considering the concrete relevance of each profile. Whenever it can be assumed that the various profiles have the same weight, the Total Score is the mean of the various profiles.

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In the absence of “robust” information, the “strategic risk”/“governance and control systems” and “operational and reputational risks” profiles contribute to the analysts’ total score as a single profile.

In attributing the Total and Profile Scores in off-site analysis, the evaluations made in recent inspections shall be taken into account, especially if they concern the same issues.

The “unified evaluation grid” is as follows:

Table 2

EVALUATION GRID

a	STRATEGIC RISK, GOVERNANCE AND CONTROL SYSTEMS	1-6 (*)
b	CREDIT RISK	1-6
c	FINANCIAL RISKS (market, counterparty, interest rate, liquidity)	1-6
d	OPERATIONAL AND REPUTATIONAL RISKS	1-6 (*)
e	PROFITABILITY	1-6
f	CAPITAL ADEQUACY	1-6
	OVERALL ASSESSMENT	1-6

(*) weighted 50% in off-site analysis
whenever “robust” qualitative
information is not available

II.5 The “score-action” connection

The RAS results are the basis for the subsequent supervisory actions; these are very different, ranging from an ordinary oversight action to corrective measures, in extreme cases of an extraordinary nature. Such actions might be directed to specific/cross-cutting risk profiles or to the general situation of the intermediary.

In deciding the most appropriate supervisory action, special attention needs to be paid to situations where the Total Score:

- results from the mean of differing Profile Scores; in such cases, action needs to be primarily directed to those profiles showing deficiencies;
- is steadily negative or appears to be worsening; in such cases, supervisory controls shall be increased.

The actions typically ensuing the attribution of the different scores are illustrated below.

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The following indications are for simple orientation, as the most appropriate actions are decided on a case-specific assessment in accordance with the criteria illustrated in Part 2 of this Guide.

SCORE 1: GOOD

The judgment on the analysis profiles is positive and the general situation of the intermediary is more than satisfactory; there are no weaknesses in any of the profiles considered.

Controls are performed according to the ordinary procedures and deadlines described in this Guide.

SCORE 2: SATISFACTORY

The evaluation of profile analysis is largely positive and shows a generally satisfactory position of the intermediary; possible weaknesses affect limited operational areas and do not influence the general situation of the intermediary.

Controls are carried out according to the ordinary procedures and deadlines described in this Guide.

SCORE 3: BROADLY SATISFACTORY

The situation, although generally satisfactory, shows some weaknesses.

It is necessary to more accurately examine the profiles showing greater problems, constantly monitor them and consider if early action is necessary, also considering the general situation of the intermediary especially when the current score is worse than the earlier ones.

SCORE 4: BROADLY UNSATISFACTORY

The situation shows some critical aspects calling for special attention because their negative evolution may have a damaging effect on the general stability of the intermediary.

The assessment profiles showing the most critical points need to be examined more carefully. Regular meetings with the corporate officers allow to check their awareness of the difficulties and the autonomous decision of coherent initiatives. The validity of these actions needs to be checked, evaluating objectives, timing and details of their implementation. In their absence or should they be insufficient, action shall be stimulated, considering whether corrective measures are necessary with progression and intensity proportionate to the existing problems. The effectiveness of the measures implemented by the intermediary should be continuously monitored.

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SCORE 5: UNSATISFACTORY

The intermediary shows an anomalous situation revealed by one or more of the following elements: an unstable financial/capital equilibrium; very high levels of risk without the necessary organisational and operational safeguards; remarkable breaches of regulations that will almost certainly impact on the intermediary's reputation.

In such situations, a close monitoring by the Supervision is necessary because any further deterioration could definitively disrupt the overall operational stability of the intermediary.

The necessity for timely and adequate corrective measures needs to be considered – convoking the corporate officers when needed; this might entail a request for a comprehensive reorganisation plan. The implementation of the corrective measures requested needs to be monitored, replacing them with more effective ones should they not determine the expected results in due time.

Crisis procedures might also be decided.

SCORE 6: WEAK

This score indicates a severely anomalous situation due to the presence of one or more of the following elements: serious capital inadequacy, serious and repeated irregularities and/or violations of supervisory regulations, significant and sustained shortcomings in the organisation and management, and widespread and prolonged unreliability of information supplied to the Supervision.

The most appropriate decisions shall be taken in these situations included, if necessary, the crisis procedures.

II.6 Macro-categories and articulation of the Supervisory Review and Evaluation Process

II.6.1 General guidelines

The proportionality principle is the basis of the supervisory review and evaluation process in terms of both intensity and frequency of assessments.

The following guidelines are provided to supervisory units for orientation purposes; it is possible to deviate from the set analysis pattern to change frequency or intensity of controls in view of the relevance and/or problems of the intermediary with respect to its macro-category.

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In particular, the extent and depth of the analysis have to be adjusted for problematic intermediaries or those showing anomalies in specific risk areas or cross-cutting profiles, to detect the origin of these events and their possible consequences, especially for those financial aspects which may be the cause of the difficulties.

The planning phase has a fundamental relevance in this process. As every other SREP phase, it is based on the classification of the intermediary, in order to identify all the relevant risks and, more generally, the priority areas of analysis.

The following aspects must also be considered:

- a) with regard to groups, their structure and complexity, their risk and profit areas, and the way the parent undertaking performs its functions;
- b) with regard to groups having a significant international presence, the Bank of Italy's responsibility as the home supervisor for identifying, in cooperation with the other supervisory authorities involved (i.e. the host supervisors), the countries where the group has a remarkable risk exposure or those in which the group's subsidiaries have a systemic relevance owing to the structure of local markets. This information is also essential to correctly structure the relationship with host supervisors in performing the supervisory review and evaluation process, especially in terms of activities to be carried out – jointly or separately – considering the respective skills;
- c) with regard to intermediaries with “authorized systems”:
 - the possibility to use a larger amount of qualitative information on risk management systems and, more generally, organisational processes;
 - the need to establish a permanent interaction (especially with the risk management and auditing structures) to timely identify the necessary changes to the processes underlying the risk measurement systems, also in order to ascertain that the requirements for the prudential recognition are complied with an ongoing basis.

II.6.2 Structure of the process

The main steps of the Evaluation Cycle – coherent with the proportionality principle – for the 5 macro-categories, are detailed below:

A. planning;

B. control and analysis;

C. evaluation.

Their main features are summarized in a table at the end of this Chapter.

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A. Planning

For the first two macro-categories (i.e. intermediaries having a significant international presence or systemically-relevant nationwide) – characterized by a high complexity – the length of the evaluation cycle, the international cooperation requirements, the macro-prudential supervisory profiles and the dialogue with the corporate officers take on particular importance.

The evaluation cycle may last in both cases more than one year, up to a maximum of 36 months (24 months for nationwide systemically-relevant intermediaries). During the overall evaluation cycle, all main risk-related areas need to be accurately analyzed.

The international co-operation requirements are a distinct feature of controls on the intermediaries of macro-category 1, to be met taking into account the CEBS guidelines concerning information exchange among supervisory authorities¹⁷. With regard to macro-category 2, control planning may require sharing choices with foreign supervisory authorities, although with a minor involvement vis-à-vis the preceding category (i.e. through a bilateral exchange of information).

For the first two macro-categories the indications supplied by the structures dedicated to macro-prudential analysis have a special value.

While planning the analysis of the first two macro-categories, the results of the interaction with the group structures – especially internal audit, risk management and the other control functions (including that of compliance) which is nearly continuous with macro-category 1 intermediaries – also needs to be taken into account.

Due to the complexity of macro-categories 1 and 2, the areas to be controlled need to be indicated annually, specifying the instruments to be used (off-site detailed analysis, requests for information, meetings with corporate officers, inspections). The extent and intensity of the on-site activity, as well as the most appropriate type of visit, are agreed with the Supervision Inspectorate beforehand.

For these types of intermediaries, the considerable size usually requires targeted inspections, with a frequency commensurate to their relevance, complexity and possible weaknesses; a full-scope access may concern, if necessary, individual intermediaries belonging to groups, including the parent undertaking.

For the other macro-categories, activities are planned on a uniform annual timeline, giving priority to the most problematic intermediaries also for the planning of inspections. In general, for the macro-category 3 targeted inspections are preferred; for macro-categories 4 and 5, full-scope inspections are more commonly chosen also taking into account the time elapsed from the last inspection.

¹⁷ Cf. “Guidelines for co-operation between consolidating supervisors and host supervisors” of 25 January 2006.

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The planning of assessments, including inspections, of asset management companies operating with retail investors is more detailed.

For intermediaries in difficulty (i.e. total score 5 or 6) and for those showing specific problems, the analysts determine the assessments to be carried out in addition to the standard ones; likewise, inspections – including targeted ones – can be performed independently from the planned frequency, to satisfy newly-emerged information needs.

B. Control and analysis

For the first two macro-categories, the particular complexity of the ICAAP process requires an in-depth evaluation of the annual report, of measurement results, of the organizational structure and of the models used for Pillar One and Pillar Two risk integration.

For the third macro-category (i.e. medium-large intermediaries), the analysis is limited to the verification of completeness of the risk categories taken into account if the intermediaries adopt simple methods to determine their total internal capital.

With respect to those intermediaries measuring risks by means of above-standard methodologies or that use models to integrate different risks, the analysis needs to be extended also to these aspects starting a dialogue with the company structures involved in the process.

For the fourth macro-category (minor intermediaries), in the majority of cases the analysis of the ICAAP report may make the start of a specific interaction superfluous.

In general, the ICAAP results, that have an annual period of validity, contribute to the planning of the subsequent assessment activity.

The assessment of the exposure to risk is based, for the first two macro-categories – along with the models fed by prudential returns – on data generated by possible authorized internal systems. The interaction with the risk management functions of those intermediaries also allow to enrich the analysis with ad-hoc calculations concerning specific operational sectors and/or legal entities.

For macro-categories 3 and 4, the annual risk exposure analysis is normally based on the results of the models fed by the prudential returns.

For all macro-categories, the information sources to evaluate the organizational arrangements of risks, governance and control systems include: (i) ICAAP report; (ii) individual and consolidated financial statements; (iii) public disclosure; (iv) any documentation about the organization and risk management that the intermediaries are required to submit; (v) the results of examinations carried out by the internal auditing function; (vi) the results of the inspections by the Supervision; (vii) information obtained from other supervisory authorities, the judicial authority, customers or other subjects by means of complaints or petitions.

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For macro-categories 1 and 2 significance is also given – with a different degree of importance – to all the information offered by foreign supervisory authorities.

For those entities subject to particular regulation, assessments are based on models fed by the prudential returns (if required) and, for qualitative aspects, essentially on inspection findings.

In particular, without prejudice to what is set out in the specific Chapters about the entities subject to the supervisory processes:

- with regard to the investment firms not subject to prudential requirements, the evaluation is exclusively based on the verification of cross-cutting profiles of governance and control systems, of profitability and of capital adequacy (only for compliance with minimum capital requirements);
- with regard to EMIs the simplified Verification Pattern is based on the verification of capital adequacy (only for compliance with capital requirements);
- with regard to Intermediaries 106, the communications regarding changes to the requirements for inclusion in the General Register are verified.

C. Evaluation

For the first two macro-categories, the possible planning of assessment activities over more than one year is joined to the attribution of the annual total score. This summarizes the annual scores on the quantitative components of risks and on profitability and capital; this evaluation also takes into account the analysis performed over the year on qualitative components, making reference to previous evaluations for sectors not subject to control.

For macro-categories 3 and 4, the annual assessment summarizes the profile judgments made at the same time.

A summary judgment on compliance with applicable regulation – not a score – is envisaged for macro-category 5 intermediaries.

II.7 Relationship between consolidated and individual assessments

The policy adopted for the supervisory review and evaluation process gives priority to the consolidated approach vis-à-vis the individual one. However, for intermediaries that are "relevant entities" in their groups, the controls and assessments on the group are also carried out on an individual basis, according to the standards and methods envisaged for each risk area and cross-cutting profile (see the relevant Chapters).

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Against this background and without prejudice to the specific indications given on each Analysis Scheme, “relevant entities” are to be designated within groups as follows:

- a) the parent undertakings, without prejudice to point d) below;
- b) the intermediaries listed on financial markets and those having significant minority shareholders (above 20%);
- c) asset management companies;
- d) the “risk-taking” intermediaries (conventionally, those absorbing individually between 30% and – also for the parent undertaking – 80%¹⁸ of the consolidated capital requirement¹⁹);
- e) the intermediaries providing key business processes to the group (e.g. depository banking, investment banking).

Depending on the specific features of each group and the consequent in-depth examination needs, the analyst decides whether to consider “relevant entities” other subsidiaries outside the components categories listed above whenever they entail a remarkable reputational risk for their group (e.g. intermediaries that solely or mainly use an external distribution network) or have a Total Score of 5 or 6.

With reference to the non-relevant entities:

- the compliance with supervisory regulations shall be checked and the financial statements have to be evaluated;
- the automatic scores given by the RAS need to be monitored and confirmed by calculating the Total Score as the mean of the automatic Profile Scores;
- analysis of the qualitative aspects of risk areas are not needed.

At any rate, if the group Total Score is negative (5 or 6), an in-depth assessment of the most problematic group subsidiaries shall be carried out.

The individual analysis performed according to the above-described standards allows the collection of information useful for the consolidated evaluation.

In general, the added value of the individual analysis is in the accuracy of qualitative assessments; the focus on the relevant intermediary allows, in fact, to better evaluate the organizational solutions adopted by the group to control risks.

¹⁸ In fact, where one intermediary absorbs more than 80%, the consolidated assessments tend to be coincident with the individual ones for the same intermediary.

¹⁹ For investment companies complying with the “other risks” coefficient, this is considered equivalent to that for operational risk.

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II.8 Inspections planning and interaction between off-site controls and inspections

II.8.1 Inspections planning

Frequency and type of inspections are adjusted on the intermediaries' size and problems.

They are normally based on an annual planning that takes into account the intermediaries features and the need for in-depth controls emerged in the supervisory activity.

Assessments can also be undertaken independently from planning whenever urgent needs arise, also in view of possible actions.

(text omitted)

II.8.2 Interaction between off-site controls and inspections

The methodological and operational integration as well as the useful interaction between off-site controls and inspections are key for an effective and efficient pursuance of the supervisory purposes.

The coordinated use of analysis and evaluation instruments allows in fact to adequately exploit the information gathered and the results obtained, to avoid duplication of activities, to rationalize the use of resources, to make the analysis quicker, to ensure unity to the supervisory process.

(text omitted)

The integration of the Supervisory Review and Evaluation Process also requires a close co-ordination of methods and contents of communication between the Supervision and the intermediaries. In this respect, the remarks and observations presented in the inspection report and in any annexed letter of intervention become relevant.

The necessity of a clear and efficient communication with the intermediary implies a full complementarity of the above-mentioned documents, the difference being represented by the distinction between the fact-finding and intervention phases, which respectively materialize in the inspection report and the annexed letter.

In particular:

- in the part formally presented to the supervisory body of the inspected intermediary, the inspection report contains a complete illustration of the operational profiles and the compliance aspects emerged from the inspection, providing every useful information for a full understanding of the observations expressed;
- the letter of intervention (see Part 2 of this Guide) contains indications and supervisory actions resulting from the inspection; in particular:

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- it points out to the sectors in need for corrective or preventive actions, providing references to the sections of the inspection report presented to the intermediary;
- if sent after some time, it summarizes the main elements emerged from the analysis of the corporate officers' comments on the inspection remarks, illustrating the consequent observations of the Supervision;
- indicates the operational aspects in need for actions by the intermediary to resolve the problems highlighted in the inspection report and states any corrective measures required under the regulation in force.

(text omitted)

II.9 Relationship between the analysis of individual intermediaries and the macro-prudential analysis

II.9.1 *Stability and crisis on a micro and macro-prudential level*

The sound and prudent management of individual entities and the stability of the financial system are complementary objectives: the problems of one intermediary may impact on other entities through the markets, determining macroeconomic effects; the difficulties of big undertakings or key intermediaries in the payment and settlement systems may spread to other entities, with contamination effects and macroeconomic consequences; aggregated shocks of a real and/or financial nature may have repercussions on the whole system or individual intermediaries.

The macro-prudential analysis has preventive purposes, aiming to find vulnerabilities in the financial system which might take on systemic proportions and affect the industrial activity.

The macro-prudential analysis is also characterized by some specificities:

- a) focus on the financial system as a whole;
- b) intense supervision on systemically-relevant intermediaries and on those highly specialized, which are more exposed to the typical systemic risks of their business segment;
- c) analysis of the exposure to macro-economic risks, also taking their dynamism into account;
- d) analysis of the mechanisms of risk amplification determined by adverse collective behavior.

Macro-prudential analysis and micro-prudential controls are part of an interactive approach structured into several steps:

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- individuation of risks and structural vulnerabilities that in case of adverse plausible circumstances may affect the financial system as a whole or specific segments²⁰;
- identification of shock transmission mechanisms, distinguishing between areas where shocks have immediate effects and areas where they spread at a later stage because of interactions between the real and financial economy or among the financial market operators;
- prior assessment of vulnerabilities in terms of event probability and possible impact, also by means of stress tests;
- verification of the permanence of risk factors among intermediaries and/or in the reference markets (e.g. by means of specific/targeted inspections or off-site controls);
- evaluation of the possible systemic relevance of risk factors emerged during the above-mentioned analysis;
- planning of supervisory actions to mitigate the potential impact of the vulnerabilities found (e.g. through recommendations to the system).

The described evaluations and interventions are implemented through the integration in supervision of a macro-prudential approach, following a path “from macro to micro” (from issues systemically relevant to their effects on intermediaries) and “from micro to macro” (from individual behaviors to phenomena of potential systemic relevance).

II.9.2 From macro- to micro-prudential analysis

The macro-prudential analysis gives a cross-cutting view of the supervision on individual intermediaries, allowing targeted researches and in-depth studies on particularly relevant and general issues that concern many intermediaries or a sector or the market. It aims at identifying the systemically relevant vulnerabilities, to be properly taken into account by the analyst in the assessment process to make supervisory action proactive.

Identifying and defining the sources of systemically relevant vulnerabilities to be studied is a complex and integrated process which requires a large amount of different information: results of off-site controls and inspections, information provided by the intermediaries themselves, monitoring of markets, sectoral and conjunctural analysis, ad-hoc inquiries, data possibly obtained from other supervisory authorities, the judicial authority or customers through complaints.

In defining systemic risks and in identifying priorities the size of the concerned entity and the dimension of the phenomenon shall be considered, to gauge the impact of the problem and its probability of occurrence. In a proportionality perspective, the evaluation of the

²⁰ For this purpose, *aggregate* shocks, that have repercussions on the financial system as a whole, and *idiosyncratic* shocks, that hit one or more entities or sectors, shall be distinguished. Shocks can also have a real or a financial nature.

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probability of systemic risks and their impact should allow to establish an order of priority in supervisory actions.

II.9.3 From micro- to macro-prudential analysis

For the purposes of macro-prudential analysis, the systemically relevant intermediaries have to be taken into consideration (indicatively, those included in the macro-categories 1 and 2), potentially able to shake the financial system stability. These are intermediaries which, due to their dimension, can hinder or jeopardize the activity of other market operators or limit the smooth functioning of the system and its infrastructures even in case they have just transitory difficulties.

Dialogue and cooperation among the various Supervision Departments foster the ability of structures to evaluate the trend of systemic risks when performing the Supervisory Review and Evaluation Process.

When high risk is found in the behavior of individual intermediaries or a group of them with potential negative systemic repercussions, the Supervision Departments consider the opportunity of specific controls within macro-prudential analysis.

To this end, occasions for dialogue and exchange of information are envisaged between those in charge of macro-prudential studies and analysts/inspectors, such as the participation of the macro-prudential experts in the meetings with corporate officers or in inspections on matters of common interest with a possible systemic relevance.

II.9.4 Stress tests

Stress tests are tools used in the macro-prudential analysis to get a prospective assessment of the system's soundness and of possible vulnerabilities to shocks on one or more risk factors. Together with market information, the stress tests targeted to the financial system as a whole assist in strengthening the effectiveness of the control activity and directing the supervisory action to the prevention of prospective risks. They are a standard exercise in the Financial Sector Assessment Program (FSAP) of the International Monetary Fund to assess the soundness of national financial systems.

The macro-prudential analysis shall identify the risk factors to be subject to sensitivity and scenario analysis, i.e. to define the factors potentially subject to shocks and the economic crisis scenarios on to which to calibrate the stress tests. Such studies give an input to macro-prudential analysis, that has to take into account the impact of the stress scenarios on the soundness of individual intermediaries, also to evaluate the ICAAP process carried out by each intermediary.

The macro-prudential analysis selects those plausible scenarios that may cause instability events choosing amongst historic scenarios, probabilistic scenarios adjusted on the observed distribution of risk factors, hypothetical

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scenarios relating to future events never recorded in the past, and “reverse engineering” scenarios, susceptible to have a major impact on the solidity of intermediaries and of the system. Macro-prudential analysis is completed by the definition of the shock transmission channels.

When defining stress tests, the probability of exceptional events, the time horizon to be assumed for the full realization of the shock effects, and how to take account of the possible feedback effects need to be considered. The probability that adverse scenarios may materialize must be considered in relation to the current conditions of the financial environment (conditional scenarios).

In the micro-prudential analysis of the selected scenarios, the assessment of the possible amplification effects determined by collective, adverse behavior of the market operators (“herd behavior”) shall be carefully considered.

SREP PHASES AND ACTIVITIES	MACRO-CATEGORIES				
	1) Intermediaries having a significant internat. presence	2) Nationwide systemically-relevant intermediaries	3) Medium-large intermediaries	4) Minor intermediaries	5) Intermediaries subject to specific regulation
Frequency	Up to 36 months	Up to 24 months	Annual	Annual	Annual
Specificities	Stable cooperation with foreign supervisory authorities	Possible connections with foreign supervisory authorities	Priority to intermediaries in difficulty	Priority to intermediaries in difficulty	Minimal controls on standard frequencies
	Strong interdependencies with macro-prudential analysis	Interdependencies with macro-prudential analysis			
	Continuous interaction with Internal audit, risk management, compliance and frequent interaction with the control function (Audit Committee)	Frequent interaction with internal audit, risk management, compliance and case-by-case with the control function (Audit Committee)	On a case-by-case basis, interaction with internal audit, risk management, compliance	On a case-by-case basis, interaction with corporate officers and internal audit	
II. ANALYSIS AND CONTROLS					
1) Controls on compliance with prudential requirements	Groups: semi-annually; quarterly for large exposures. Other entities: quarterly	Groups: semi-annually; quarterly for large exposures. Other entities: quarterly	Groups: semi-annually; quarterly for large exposures. Other entities: quarterly	Groups: semi-annually; quarterly for large exposures. Other entities: quarterly	Quarterly (except Intermediaries 106)
2) Assessment of financial statements	Annual	Annual	Annual	Annual	Annual (except Intermediaries 106 not obliged to submit the financial statements)
3) Assessment of disclosure	Annual	Annual	Annual	Annual	
4) Assessment of the ICAAP	Annual; accurate assessment; targeted inspections involving foreign supervisory authorities	Annual; accurate assessment, possibility of targeted inspections	Annual; in-depth assessment if non-standard methodologies are used	Annual; normally, simplified assessment	
5) Risk analysis	In line with planning	In line with planning	Annual	Annual	
6) On-site inspections	Mainly frequent targeted (d) or follow-up (b) inspections	Mainly targeted (d) or follow-up (b) inspections, less frequent than category 1	Mainly targeted (d) inspection with regular frequency (c)	Mainly full-scope with regular frequency, except specific needs	Mainly full-scope with regular frequency, except specific needs
III. OVERALL ASSESSMENT					
Frequency	Annual (a)	Annual (a)	Annual	Annual	
IV. FOLLOW UP-MONITORING	In line with planning and the development of the entity situation				

(a) Previous evaluations are confirmed for the profiles not assessed in the year.

(b) Possible full-scope inspections on large entities, only if strictly necessary.

(c) Full-scope inspections on intermediaries in difficulty or small ones.

(d) Full-scope inspections on individual intermediaries in groups, including the parent undertaking.

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(text omitted)

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CHAPTER IV

Coordination with other Authorities

IV.1 Introduction

In performing its supervisory functions, the Bank of Italy cooperates and coordinates its activities with the other national authorities that control intermediaries and activities in the financial sector: the *Commissione Nazionale per le Società e la Borsa* (CONSOB), the *Istituto per la Vigilanza sulle Assicurazioni Private e di Interesse Collettivo* (ISVAP), the *Commissione di Vigilanza sui Fondi Pensione* (COVIP) and the *Autorità Garante della Concorrenza e del Mercato* (AGCM).

In general, the supervision performed by the Bank of Italy is part of the legal regulatory and control system on the financial sector which implies institutional relations with the Government, the Judicial Authority, other national administrations and institutions including the Finance Police ¹ and the *Garante per la Protezione dei Dati Personali* pursuant to the Personal Data Protection Code.

Finally, the Bank of Italy also cooperates by exchanging information and otherwise with the competent Authorities of the European Union and the third-countries for the purpose of facilitating the performance of their respective functions.

The main aspects of the relationship with these Authorities in the performance of controls are described in the following paragraphs.

IV.2 Relationship with the CONSOB

The 1998 Consolidated Law on Finance assigns to both the Bank of Italy and CONSOB the supervision on intermediaries authorized to provide investment services and asset management. In pursuing the general purposes of supervision on the activities regulated by the 1998 Consolidated Law on Finance ², the Bank of Italy is responsible for limitation of risk, capital stability and sound and prudent management of intermediaries; the CONSOB is responsible for transparency and correctness of conduct.

¹ Pursuant to Art. 22 of Law 262/2005, in performing its powers of off- and on-site supervision, the Bank of Italy may avail itself of the Finance Police for specific verifications. A Memorandum of Understanding has been signed, on 26 July 2007, by the two institutions to establish forms of mutual cooperation.

² In particular: a) the safeguarding of faith in the financial system; b) the protection of investors; c) the stability and correct operation of the financial system; d) competitiveness of the financial system; e) the observance of financial provisions (cf. Art. 5, par. 1 of the 1998 Consolidated Law on Finance).

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Each authority is responsible for the compliance with laws and regulations according to the distribution of responsibilities described above. Both authorities have to operate in coordination and notify each other of the measures adopted and the irregularities discovered in carrying out their supervisory activity, as per their Memorandum of Understanding of 31 October 2007.

The Memorandum regulates the duties of each Authority and how they are performed, the mutual exchange of information (also with respect to the irregularities found and to the measures taken), the mutual obligation to cooperate in granting authorizations as well as in the performance of supervision (regulation; off-site; on-site) ³. In this respect, the following has to be taken into account:

- with regard to the duties of the Bank of Italy and in particular those related to the supervisory review and Evaluation Process, the CONSOB transfers to the Bank of Italy all the information that may significantly impact on the intermediaries' exposure to risk, particularly to the operational and reputational risk ⁴;
- both Authorities exercise their inspection powers within the respective competencies and promptly inform each other on the inspections they have started (specifying their scope), steering the control methodologies to the pursuance of their respective duties and establishing the opportune forms of cooperation on inspections; significant profiles falling within the other Authority's responsibility found during inspections are urgently reported;
- for the profiles it is legally responsible, one Authority can ask the other Authority to carry out inspections. In the event: the request shall be timely; the scope of the analysis has to be clear; the forms of cooperation and the procedures for the controls shall be inspired by efficiency;
- a "Strategic Committee" and a "Technical Committee" are set up. The purpose of the former is to study and exchange information on matters relevant for the coordination of supervision, to define modes of communication following controls and to solve any issue on the implementation of the Memorandum; the Technical Committee is tasked, inter alia, with the implementation of the guidelines of the Strategic Committee.

³ See <http://www.bancaditalia.it/vigilanza/accordi>

⁴ Symmetrically, with regards to the verification of the transparency and correctness of conduct the Bank of Italy transfers to the CONSOB all the information that may significantly impact on the assessment of the intermediaries' practices and procedures in the provision of investment services and activities. Moreover, the two Authorities timely report to each other every decision and measure adopted on intermediaries having effect on the provision of investment services and activities (order the convening of the governing bodies, suspension of management bodies, restrictive and injunctive remedies, suspension/limitation to place/reimburse shares of CIUs, proposal for special administration or compulsory administrative liquidation).

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In the evaluation process, the analysts take into account all the information provided by the CONSOB.

IV.3 Relationship with the ISVAP

The institutional cooperation between the Bank of Italy and the ISVAP is articulated into three separate but related topics:

- exchange of information and coordination of supervisory action, whenever financial relationships (principally, shareholdings) exist among the undertakings supervised by each Authority. The cooperation mainly takes the form of preliminary consultations on some corporate events (e.g. the establishment of a subsidiary in one sector by a parent undertaking active in the other sector, or the acquisition of significant cross-sectoral shareholdings by a supervised entity) ⁵. Moreover, the offices supervising the banking and insurance intermediaries that are part of conglomerates usually exchange information on ownership structure, data on operations and capital, and on the supervisory actions taken by each Authority on the parent undertakings or subsidiaries of banking and financial intermediaries;
- coordination of methodologies for the supplementary supervision on financial conglomerates. Such cooperation takes place in the Technical Working Group on Conglomerates, set up by the Bank of Italy, the CONSOB and the ISVAP as a coordination and cooperation forum for the definition of the necessary actions to start in Italy the supervision on financial conglomerates, following the transposition of the Financial Conglomerates Directive (c.f. the Legislative Decree n. 142/2005). – The Technical Working Group: identifies the conglomerates; drafts Memoranda of Understanding; defines the supervisory methodologies and the procedures for implementing the Legislative Decree n. 142 of 2005, in line with the guidelines agreed at the European level in the Interim Working Committee on Financial Conglomerates;
- joint studies on regulatory or prudential issues impacting on both sectors, i.e. to update the criteria to determine the banking or financial nature of undertakings ⁶ or to implement the IAS-IFRS standards.

IV.4 Relationship with the COVIP

In regulating the supplementary pensions schemes, the Legislative Decree 252/2005 has subjected all such schemes to the supervision of the COVIP, to pursue the sound and prudent management of pension funds as well as the transparency and correctness of their conduct to protect members and

⁵ Articles 15, par. 2, and 19, par. 2, of Directive 2006/48/EC.

⁶ Cf. Article 2, Decree of the Minister for the Economy and Finance n. 933 of 27 December 2006.

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beneficiaries of all types of supplementary pension schemes and the smooth functioning of the supplementary pensions system⁷.

Exchange of information between Banca d'Italia and COVIP typically concern the management of pension schemes by banks, investment firms and asset management companies that have:

- contracted specific mandates with an institution for occupational retirement provision (Art. 6, par. 1 of the Legislative Decree 252/2005);
- established open-ended pension funds. In particular, the authorization to set up the fund shall be granted by the COVIP following the Bank of Italy's legal opinion (Art. 12, par. 3 of the Legislative Decree 252/2005). In this case, the most important prudential aspect may consist in a guarantee given by the intermediary for the repayment of the principal and/or the yield.

The cooperation with the COVIP may also concern the depository banks of pension funds' assets (cf. Art. 7 of the Legislative Decree 252/2005).

IV.5 Relationship with the AGCM

With regard to the distribution of responsibilities on competition and market protection and the related coordination needs, the Bank of Italy and the AGCM, pursuant to the Law 262/2005, have established a cooperation agreement regulating in particular the procedures for the exchange of information⁸.

In particular, the AGCM shall transfer to the Bank of Italy:

- on the latter's request, all information deemed useful for the assessments of mergers involving banks;
- on its own initiative, the decisions to open and close inquiries on mergers impacting on the banking markets.

⁷ Pursuant to the Decree, the COVIP, without prejudice to its previous tasks concerning institutions for occupational retirement provision, has extended its competencies on open-ended pension funds and individual schemes, taking on a set of new responsibilities for individual pensions and for some categories of outstanding pension funds. In fact, the funds already established at some institutions, companies or banking and insurance groups are now subject to supervision by the COVIP. In addition, the COVIP: a) authorises the pension funds and the contracts for the management of the funds' assets by eligible intermediaries; b) approves the funds' bylaws and mandates as well as their subsequent modifications; c) evaluates the implementation of the transparency obligations in the relations with the funds' members; d) controls the operational, financial, capital and accounting management of funds, also by means of inspections.

⁸ CfCf. <http://www.bancaditalia.it/vigilanza/accordi/BI-AGCM.pdf>. The agreement establishes, inter alia, the data that the Bank of Italy must promptly transfer to the AGCM authority, if requested by the latter, on the merger deals under Art. 16 of the Law 287/1990 that may have repercussions on the banking markets for deposit and lending.

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IV.6 Relationship with foreign Supervisory Authorities. The Colleges of Supervisors

Cooperation with foreign Supervisory Authorities is essential to carry out the Supervisory Review and Evaluation Process on cross-border groups, especially those having systemic relevance in the EU; in this respect, the home supervisor, being responsible for consolidated supervision, plays a special role.

The College of Supervisors is the most common instrument in the supervision of cross-border groups.

The Colleges are permanent structures created by the Supervisory Authorities (both home and host ⁹) significantly involved in the supervision of groups operating internationally. They allow exchange of information, convergence of approaches and supervisory methodologies, and coordination of operational activities ¹⁰.

In this respect, the home supervisor has to perform a propulsive function with reference to all steps of the Supervisory Review and Evaluation Process, mainly to the planning phase ¹¹. The home supervisor steers the College to form a full picture of:

- a) the total risk profile of the group;
- b) the internal methodologies used to measure risks on a consolidated basis.

The first aspect requires the home supervisor – also in cooperation with the other authorities – to draw a group “mapping” (type of risks taken, business lines, legal entities and countries of establishment), identify the relevant components and the host supervisors ¹² and draft a first assessment of risk.

As to the second aspect the home supervisor – with the assistance of the parent undertaking – supplies the other Authorities with information on the most significant projects of common interest that are being implemented on a consolidated level (first and foremost on internal risk measurement

⁹ The latter are responsible for the supervision on group corporations other than the group leader established in its home country.

¹⁰ Other instruments with which to perform cooperation among Authorities are “operative networks” and the written cooperation agreements (bilateral or multilateral). The “operative networks” are essentially working groups among supervisors aiming to strengthen the consistency of supervisory approaches and the exchange of information concerning matters of interest for the cross-border supervision, also identified by involving the intermediaries themselves. The cooperation agreements have, for their part, a more operational content and are binding for the participating Authorities, that may use them to guide the decision process and to delegate to the home supervisor the performance of duties other than those envisaged by the regulation.

¹¹ Cf. “Guidelines for co-operation between consolidating supervisors and host supervisors” (CEBS, January 2006).

¹² The concept of relevance is valid both on a group level and in the country where the entity is established.

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systems for calculating the capital requirements and on the ICAAP). This information mainly pertains to the methodological choices made, to the progress of their implementation, to roll-out developments and to the connected impacts on operations and organization.

In pursuing the convergence of practices, the home supervisor explains the supervisory approach adopted towards the parent undertaking (methods and evaluation criteria, Verification Patterns, activities performed) to highlight the main differences amongst the supervisory “models” of the various Authorities and the reasons underlying such differences.

The exchange of information among College members is based on a “communication protocol” made of the structured and shared set of: (i) schemes for the collection of information on the various group components; (ii) transmission infrastructures (website, email, etc.); (iii) timelines.

The meetings are important in the college activity. They shall be adequately planned as to frequency, contents and participants. They should be focused on planning, ending with the preparation of a list of activities to be implemented.

Performing jointly the supervisory tasks is the ideal occasion to know and harmonize in practice the different supervisory methods, whether off- or on-site. In fact, the College decides:

- the type of activities to be performed on the group and its components and the related deadlines, identifying the tasks to be carried out independently on the basis of the respective legal responsibilities and those to be performed jointly, including inspections;
- the communication strategy towards the supervised group. In particular, to minimize costs for the intermediaries, in due time the college gives a shared feedback on the main issues raised by the intermediaries.

Whenever the Bank of Italy is the host supervisor, the efficiency of the supervisory review process on the domestic entity depends on a productive cooperation with the foreign Authorities responsible for the supervision on the parent undertaking established in an EU country.

As a host supervisor, the Bank of Italy will contribute to facilitate the coordination of activities, offering its knowledge of the supervised entity and management and highlighting any specificities in the national supervisory approach and the underlying reasons.

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SECTION III

ANALYSIS SCHEMES FOR THE EVALUATION OF INTERMEDIARIES

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CHAPTER I

Methodologies for analysis and evaluation

I.1 Underlying logic and evaluation sequence

The Risk Assessment System (RAS) is focused on relevant risks, following a logic of “net risk” evaluation, which also includes the analysis of the corresponding organizational arrangements; such evaluation is key for strategic and operational risks.

The cross-cutting organizational aspects concerning risks are discussed in the Chapter on “Governance and control systems”: supervisory, management and control bodies macro-organization, control functions.

The risk-specific Analysis Schemes do not include the assessment of profit and capital positions, considered as a whole in their respective profiles.

The logical sequence of the Analysis Schemes in this Part of the Guide – which drives the sequence normally followed by analysts and inspectors in supervisory evaluations – is the following:

- first of all, strategic risk is examined, because of its key role in guiding strategies; then governance and control systems are assessed, as they coordinate the treatment of the various types of risk. The definition of an adequate strategy and a valid organizational and control structure is the first safeguard against the overall firm risk;
- then intermediary's relevant risks (credit, financial, operational) are assessed, following the integrated approach explained above;
- finally profit and capital adequacy, which are key elements to assess corporate risk, are considered.

Below are the main features of an Analysis Scheme step by step.

I.2 Strategic risk

Purpose of this assessment is an evaluation of strategic risk, as defined by prudential regulation. The analysis, strictly connected to intermediaries' dimension and complexity, is divided in two phases:

- the first one is qualitative and deals with how the strategic targets are set and turned into both consistent actions on the organization and adjustments in case of adverse events;
- the second one is mainly quantitative and concerns the features of the supply strategy, the variability of profit and the evolution of market shares; special attention is given to the strategies to entry new markets or launch new products.

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Both types of analysis separately result in assessments of the quality of strategic planning and of the theoretical exposure to strategic risk (i.e. high, medium, low); considered together according to the standards provided in the Analysis Scheme, they allow to determine a score.

A specific evaluation model exists for asset management companies.

I.3 Governance and control systems

Scope of the assessment is to detect any risks deriving from inadequacies of the intermediaries' governance, organization and controls.

The analysis is focused on the governance system (the ownership structure, which constitutes a driving element of the Scheme; the supervisory, management and control bodies), the organization (macro-structure, planning and control systems, information and technological systems) and the control functions (internal audit, risk management, compliance function).

The evaluation is based on analytically-selected “qualitative factors” consistent with the prudential regulations and is supplemented by markers of shortcomings in organization and controls.

The judgment is based on the short and weighted evaluation of the overall “organizational risk”, driven by the individuation of the situations typically characterizing the various levels of risk.

I.4 Credit risk

The analysis of credit risk is based on the measurement of quality and concentration of the loan portfolio and the assessment of their respective organizational safeguards.

Credit quality is studied on the basis of indicators measuring the stock and the generation rate of non-performing loans as well as the impact of the associated losses.

The analysis of the degree of concentration is based on the compliance with the regulation on large exposures and the diversification of the loan portfolio by name and economic sector.

Quantitative analyses' supplementary reports are articulated into detailed macro-areas (credit quality, resources allocation, allocation capacity, country risk, analysis of the credit portfolio by counterparty) and also include information on credit derivatives and securitizations.

The analysis of the organization – whose relevance, as for other risks, is closely related to the quality of information – is centered on checking the solutions adopted by the intermediaries to achieve efficiency and effectiveness in this field.

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The analyses on the intermediaries with “recognized systems” are supported by the specific documentation required by regulations.

I.5 Financial risks (market, interest rate, liquidity)

The assessment of financial risks is based on the evaluation of the exposure to market/counterparty, interest rate on the banking book and liquidity risk and their respective safeguards. In particular:

- the measurement of **market and counterparty risk** deriving from the dealing for own account in financial instruments is based on the ratio of VaR – calculated by the intermediary with “recognized systems” or estimated on the basis of prudential returns – and regulatory capital. The quantitative assessment phase focuses on the activity in securities and derivatives, counterparty risk and positioning strategies; it is adjusted according to the activity of the intermediary, defined by an ad-hoc classification. The analysis of organization is supported by the indication of the qualitative factors relevant for the assessment;
- the evaluation of **interest rate risk on the banking book** is based on the calculation of the variation in the economic value (present value of the future net cash flows) of the intermediary's banking book assuming a parallel shock of the interest rate term structure. The automatic score is assigned by comparing the indicator so obtained with a system of thresholds. The supplementary reports simulate more substantial variations of the interest rate structure as well as various assumptions on the sensitivity of deposits to variations in market rates. Fundamentally, the evaluation of the organization reflects the adequacy of the procedures adopted for measuring, managing and controlling this type of risk;
- controlling **liquidity risk** exposure aims at evaluating the ability – on a short timeframe (three months) – to withstand outflows of such resources, given the term structure of the balance sheet. The quantitative evaluation is completed with indicators intended to grasp the concentration of liquidity sources, the dynamics of the main financial aggregates and the multi-currency activity. The evaluation of the organization is based on: (i) quality of the management policies, (ii) calculation methods, and (iii) involvement of the control structures.

I.6 Operational and reputational risks

The purpose of such analysis is to evaluate the exposure to operational and reputational risks as defined by prudential regulation, as well as the ability to govern, manage and control them. The analysis of non-compliance risks is part of this evaluation.

The measurement of operational risks is based on the internal models for the intermediaries authorized to use advanced systems (AMA). For other intermediaries a two-step risk quantification process has to be used due to

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the limited sensitivity of the method for the calculation of the capital requirement: first, an automatic score is assigned to the risk “intrinsic” to the intermediary’s activities: second, the score is eventually rectified taking into account the ratio of the requirement and the total regulatory capital.

The examination of qualitative aspects focuses, in general, on the compliance with the management and control principles set by prudential regulations; in certain circumstances, the evaluation is extended to the business areas that typically generate such risks (asset management, investment and payment services, depository bank, corporate finance) and the IT, administration/accounting and distribution systems.

Reputational risk is estimated on the frequency of events (e.g. complaints, petitions, legal actions) symptomatic of a possible deterioration in reputation and the occurrence of other negative events (losses, repayments, etc.). The evaluation is completed by examining some operational and/or organizational factors (conflicts of interest, organizational complexity, sale of structured instruments, etc.) indicative of such risks.

The profile score is that assigned to operational risks – mainly determined on the basis of qualitative aspects – and is integrated by the reputational component, should this appear deteriorated.

I.7 Profitability

Purpose of this analysis is to evaluate the intermediary’s ability to generate profits as a durable attitude to reach a satisfactory equilibrium. A central role is specifically conferred upon the Analysis Scheme of profitability even in the case of positive results, which may indicate a risk underestimation.

The Analysis Scheme is based on a detailed understanding of the profitability capacity, considered as a “normalized” measure of profit flows.

The analysis is divided in two parts, to ascertain the adequacy and stability of income flows. Regarding the first aspect, flows are assessed in relation to the various needs in terms of use of income and the competitive framework, using a model that considers – in line with market practices – risk-adjusted indicators of profitability (RAROC). As concerns stability, the factors influencing the level of income, the contribution given by each operational area and the degree of operational efficiency are examined.

I.8 Capital adequacy

The intermediary’s capital adequacy (current and prospective) is evaluated in two successive phases:

- firstly, the capacity of complying with Pillar One capital requirements is considered. In this respect, the suitability of capital to cover the various types of risk is evaluated with reference to both the amount in excess of

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total requirements and the composition of capital, in terms of Tier 1/total capital ratio, to assess quality and stability of capital aggregates;

- secondly, the adequacy of total capital vis-à-vis all significant risks taken by the intermediary – including non-Pillar One risks – and the strategies pursued are evaluated. The analysis moves from the intermediaries' self-evaluation of their internal capital needs (also prospectively) and take into account the mitigation and risk control mechanisms devised.

The approach is the same for all intermediaries; the evaluation ladders are differentiated considering the regulatory specificities.

(text omitted)