



TECHNICAL ASSISTANCE REPORT

JORDAN

Developing Supervisory Review and
Evaluation Process SRP Framework

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Prepared By

Nehmat Hantas and Sébastien Clanet



METAC

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Acronyms and Abbreviations

| | |
|-------|--|
| ASE | Amman Stock Exchange |
| BSD | Banking Supervision Department |
| CAMEL | “Capital adequacy, Assets, Management capability, Earnings, Liquidity” rating system |
| CAR | Capital Adequacy Ratio |
| CCD | Companies Control Department |
| CBJ | Central Bank of Jordan |
| DSIB | Domestic Systemically Important Bank |
| FSAP | Financial Sector Assessment Program |
| ICAAP | Internal Capital Adequacy Assessment Process |
| IMS | Inspection Management System |
| IRRBB | Interest Rate Risk in the Banking Book |
| JODIC | Jordan Deposit Insurance Corporation |
| JSC | Jordan Securities Commission |
| LCR | Liquidity Coverage Ratio |
| METAC | Middle East Regional Technical Assistance Center |
| OSS | Off-site Supervision System |
| RBS | Risk-Based Supervision |
| ROCA | “Risk management, Operation controls, Compliance and Asset quality” rating system |
| SRP | Supervisory Review and evaluation Process |
| SREP | Supervisory Review and Evaluation Process |
| TA | Technical Assistance |

Preface

A mission from the IMF's Middle East Regional Technical Assistance Center (METAC) was conducted from November 1 to 3, 2022, at Central Bank of Jordan (CBJ) by Mrs. Nehmat Hantas, Banking Supervision Advisor at METAC, and Mr. Sébastien Clanet, a short-term expert from Banque de France. The mission's purpose was to assist the supervisors of the Central Bank of Jordan in the development of a supervisory risk-rating framework, inspired from the European Supervisory Review and Evaluation Process (SREP) methodology.

This mission was part of a multi-step project towards a full implementation of the Risk-based Supervision (RBS). It primarily focused on defining the steps needed to develop the risk rating framework with defined milestones towards implementation of SRP. It was conducted in person at the premises of Central Bank of Jordan (CBJ), in Amman, Jordan.

Meetings and discussions were held with the Head of Banking Supervision Department (BSD), Mr. Hussein Kofahi (executive manager), Mr. Marwan Said (consultant at BSD), the heads of examiners Mrs. Zeinab Al-Jaafreh and Mr. Murad Assaf and a group of supervisors from the BSD. A closing meeting was held with Mr. Hussein Kofahi and Mr. Marwan Said to discuss the roadmap, the recommendations and the next steps.

The mission wishes to express its sincere thanks to the CBJ's supervision staff for their cooperation, high level of engagement and devotion in facilitating the mission's work.

Executive Summary

In the wake of the latest Financial Sector Assessment Program (FSAP) mission, the Central Bank of Jordan (CBJ) intends to enhance its risk-based supervisory framework, notably its risk rating framework inspiring from EU Supervisory Review and Evaluation Process (SREP) and to move further towards a risk-based supervision. The core element of this project relies on the implementation a new Supervisory Review Process (SRP) approach in line with best international practices, while leveraging as far as possible on the current supervisory reporting and rating tools.

The mission suggested to design a progressive multi-step approach towards implementing a full risk-based supervision, with prioritization on building a proportionate, simple but robust SRP framework for analyzing and scoring banks, with specific scoring guidance and potential support for IT implementation (developing adequate databases and creating tools to automatize key risk indicators compilation, as well as software applications for benchmarking purposes). This multi-step approach requires defining essential milestones along with a timeline for design, conception, testing and implementation of the SRP.

The mission proposed advice on the global SRP architecture, choice of main building risks blocks to integrate into the first version of the SRP and associated quantitative aspect (KRIs) and qualitative aspect (questionnaires framing expert judgment). As a result, the proposed CBJ SRP framework should be designed to cover the analysis of the main risks of the Jordanian banking system (with high priority on credit risk), progressively adding new risks at a later stage, and provide a good balance in the weighting of its various blocks and risk analysis components to produce a robust scoring output, which can then be presented and defended in front of the supervised entities.

The mission noted that several constraints remain to be addressed during SRP implementation, most notably bridging the data gap by building a fully-fledged supervisory risk database (current financial and prudential information is fragmented) through a dedicated IT project, better delineating work allocation and responsibilities between off-site and on-site activities, and drafting new regulations required to integrate important sources of risks in the SRP (e.g. Interest Rate Risk in the Banking Book, or IRRBB).

Implementation of SRP relies on strong local supervisory expertise but will nevertheless be at least a medium-term project due to resource constraints, involving significant staff engagement. The Roadmap to SRP discussed with CBJ will support the authorities on this project.

I. Introduction

1. **The Central Bank of Jordan (CBJ) is intending to enhance its risk-based supervisory framework**, notably its risk rating framework, taking inspiration from the EU Supervisory Review and Evaluation Process (SREP) and to move further towards a risk-based supervision.

A. Mission Background

2. **The CBJ requested METAC technical assistance in developing an RBS framework in January 2022.** Since an FSAP is underway and to avoid overlap between the TA and FSAP missions, the project was started in July 2022 with a virtual workshop on risk-based supervision. The workshop presented the objectives, overall architecture, and detailed risk-by-risk analysis of the European SSM SREP, to provide CBJ with a precise example of SREP implementation.

3. **Following the workshop and upon CBJ's request, METAC conducted this mission with the aim to design**, in coordination with CBJ's staff, a progressive multi-step project towards implementing a full risk-based, proportionate, simple, and robust SRP framework for the analysis and scoring of the banks. This multi-step project requires defining major milestones for a full implementation of SRP (cf. Conclusions and recommendations section).

B. Mission Objectives

4. **The mission focused on the risk-rating framework and its related processes, which involved the following tasks:**

- Discuss the scope and adequacy of the current risk analysis tools.
- Identify how it can be leveraged upon the existing tools to develop SRP.
- Understand the Jordanian financial sector structure for proportionality considerations.
- Understand the processes for annual supervisory plans, the supervisory cycle, the decision making and corrective actions.
- Understand the current processes of SRP key tools (ICAAP /recovery plans/Stress testing), and their coordination within a larger SRP framework.
- Discuss the organizational structure, resources allocation and capacity to implement SRP.
- Discuss the adequacy of IT systems and technology to perform SRP assessment.
- Devise a roadmap on developing risk rating with defined milestones towards implementation of SRP.

II. Context

A. Structure and Characteristics of the Jordanian Banking System

5. **Jordan's banking sector is quite large within the country's domestic economy, accounting for approximately 97 percent of the financial sector's total assets.** As at the end of 2021, banks' consolidated assets totaled JD 97.7 billion. The banking system comprises 21 banks, six of which are classified as DSIB. Seven banks are domestically owned, eight are foreign-owned banks, and six are branches of foreign banks. The banking system is also quite concentrated, the total share of the five largest banks accounts for 54 percent on a domestic consolidated basis. Four Banks of the 21 banks are Islamic, with total assets around JD 11.1 billion that represents around (11.4 percent) of total banking sector assets. One of them is a foreign bank and one of them is classified as a DSIB. Jordan's largest bank has significant cross border operations, with over two thirds of its credit exposures outside Jordan. In addition to supervision of banks, CBJ supervises Microfinance Institutions, Money Exchange Companies, Insurance Companies, and Payment Service Providers.

6. **The capital adequacy ratio (CAR) for banks stood at 18 percent on a consolidated basis, as of end-December 2021, mostly made up of Tier 1 capital (95 percent), sitting well above the CBJ (14+ percent) and Basel's minimum requirements.** The CBJ requires banks to maintain a minimum CAR of 12 percent, and an additional 2 percent for banks that have a cross border operation in addition to a systemic DSIB buffer (up to 2.5 percent). Additionally, the CBJ requires banks to maintain a capital conservation buffer of 2.5 percent, and it requires a countercyclical buffer (0 percent-2.5 percent), which is currently set at zero.

7. **Regulatory liquidity stood at 141.5 percent as at end December 2021.** Asset quality has remained stable over the past several years with an adequate level of provisioning according to the authorities. Bank profits have recovered back to their pre-pandemic level, as most of the provisioning had already been taken in 2020. NPLs have slightly decreased to an average of 5 percent of total loans, with NPL coverage ratio of 79.9 percent of total classified loans. Write-offs were concentrated in some banks. However, given that the debt deferment period for affected borrowers expired in 2021, it will likely take time for the asset quality effects of the pandemic to fully manifest.

8. **Gross loans contribute to approximately 55.8 percent of total assets,** versus securities and trading related assets that accounted for 32 percent, of which the bulk is government securities. The banking system has been recording **annualized average returns on assets and equity of 1 percent and 8.3 percent** respectively ending December 2021.

B. Organization and Responsibilities of Regulatory and Supervisory Authorities

9. **The CBJ is the primary regulator and supervisor of banks.** Other supervisory authorities include Jordan Deposit Insurance Corporation (JODIC), The Jordan Securities Commission (JSC), The Amman Stock Exchange (ASE), The Companies Control Department (CCD).

10. **The CBJ continued to work on strengthening its prudential supervision of the financial sector.** The authorities also plan to improve effectiveness and efficiency of onsite inspection procedures through implementing an Inspection Management System.

11. **The CBJ uses a mix of on-site and off-site supervisory activities, with supervisory teams mainly assigned to the same individual group.** The Banking Supervision Department (BSD) consists of four offsite divisions and seven onsite supervisory groups, of which one is responsible for information technology supervision. The seven onsite supervisory groups have also some offsite duties, including analyzing banks' financials statements on a semi-annual basis, following up periodic reports and studying banks' requests. Other divisions in the Banking Supervision Departments carry out some activities on regular or ad-hoc basis to check compliance with prudential regulations. These include:

- Review and recommend banks licensing and opening of branches requests inside and outside the Kingdom.
- Analyze and monitor the financial soundness indicators of banks and check the fairness of their financial positions.
- Study the related laws, regulations, and instructions and provide the necessary recommendations for updating or amending them.

12. **The CBJ has issued a set of regulations listed below, including solvency, liquidity, and ICAAP requirement, noting that ILAAP is not yet implemented, nor other regulations which are part of SRP framework (e.g., IRRBB) are issued:**

- Regulatory Capital Instructions according to Basel III Standard No. 67/2016.
- Capital Adequacy Instructions in accordance with the amended standard No.15 issued by the Islamic Financial Services Board (IFSB), No. 72/2018.
- Legal liquidity instructions for commercial and Islamic banks.
- LCR instructions.
- ICAAP.
- Maturity Ladder for commercial and Islamic banks.

13. **For recovery and resolution processes, article 80 of the banking law no. 28 determines the measures that can be taken if any bank faces problems.** The mission has noted that the CBJ is now working on a draft guide for banking crisis management framework.

C. Regulatory Reporting and Rating Tools

14. **The Banking Supervision Departments uses the Off-site Supervision System (OSS) to receive most of the regular reports submitted by banks.** Some other reports are received as hard copies or soft copy in an excel format. This makes the available data and information fragmented and not consolidated in a well-established database system. (Cf. Appendix 1)

15. **The existing rating tools are mostly based on qualitative assessment with no automation involved of key risk indicators and rating is mainly updated during on-site missions.** The CBJ uses the CAMEL (for domestic banks) and ROCA (for foreign branches) as rating scores to assess the banks. The scores range from 1-5 where rating (1) is the best, and rating (5) is the worst. In most cases, the bank assessment is updated based on the results of onsite examination, and in special cases it may be updated based on the offsite supervision results. The bank's aggregation for the overall score is determined based on the evaluations of each of the key elements of CAMEL or ROCA, upon the professional judgment of the

inspection team. Expert judgment is framed by an approved written Inspection Manual and Rating Methodology, which include descriptions and general criteria for every assigned score.

D. Mission Summary

16. **The mission entailed capacity building of CBJ's supervisors on Risk-Based Supervision through thorough discussions and understanding of the existing approaches and tools, to define steps towards implementing SRP framework.** The mission highlighted the importance to use SRP results to determine additional capital and liquidity requirements, as well as to devise the Supervisor Examination Program (SEP) to optimize the supervisory work allocation on a risk basis.

17. **The mission carried out the following tasks:**

- (i) Described the interactions between the risk-by-risk analysis, ICAAP/ILAAP and the whole Supervisory Review and Evaluation Process (SRP).
- (ii) Illustrated how a capital add-on could be based on the results of SRP score and the assessment of ICAAP and stress testing.
- (iii) Received information on the CBJ current risk assessment methodology (through CAMEL and ROCA tools).
- (iv) Discussed the adequacy of the regulatory and supervisory frameworks for the implementation of SRP, as well as the availability of the various information and data needed for the assessment.
- (v) Discussed the main steps towards transition to RBS and devised a roadmap for this purpose.

III. Conclusions and Recommendations

18. **While the actual CAMEL and ROCA rating systems encompass the evaluation efforts of the different supervisory teams of the risks of individual banks (with a strong focus on credit risk),** their implementation relies on qualitative guidance with lack of quantitative risk indicators to anchor the rating. The scoring approach might be improved by transition to SRP approach through i) a reinforcement of the both quantitative (scoring of risks through key indicators) and qualitative analysis (guidance through specific questionnaires), and ii) development of written rationale linking the results of risk-analysis to final score, capital/liquidity requirements and other supervisory measures.

19. **RBS and SRP being very data-dependent, the adequacy, quality and depth of supervisory data may still prove to be a challenge to build a sound and fully functional SRP framework.** As the current data sources remain fragmented and they are received in various formats (hard and soft copies on excel formats), it remains a challenge to compile automatically risk indicators covering all the main blocks of SRP, calibrate the scoring system based on statistical methods, enable peer comparisons, or build a historical perspective in terms of risk analysis (i.e., through the cycle instead of point-in-time). An IT effort, whether external or internal, is likely necessary to alleviate the data constraint. Lack of implementation of such an IT project would entail additional burden on examiners in terms of time-consuming manual compilation of required key risk indicators.

20. **The degree of formalization of the annual review of banks by the supervisors as well as the risk analysis remain limited.** Currently, the risk assessment is carried out mainly through the onsite missions, which are mostly comprehensive and are sometimes interrupted to carry out more compliance-oriented obligations stemming from applicable laws like banks' yearly financial statement validation. This is leading to longer and less risk-focused onsite missions.

21. **The CBJ should ensure that responsibilities between offsite and onsite functions for the implementation of the SRP approach are clearly defined and well-articulated and revise the organization of the Banking Supervision Department organization accordingly, where necessary.**

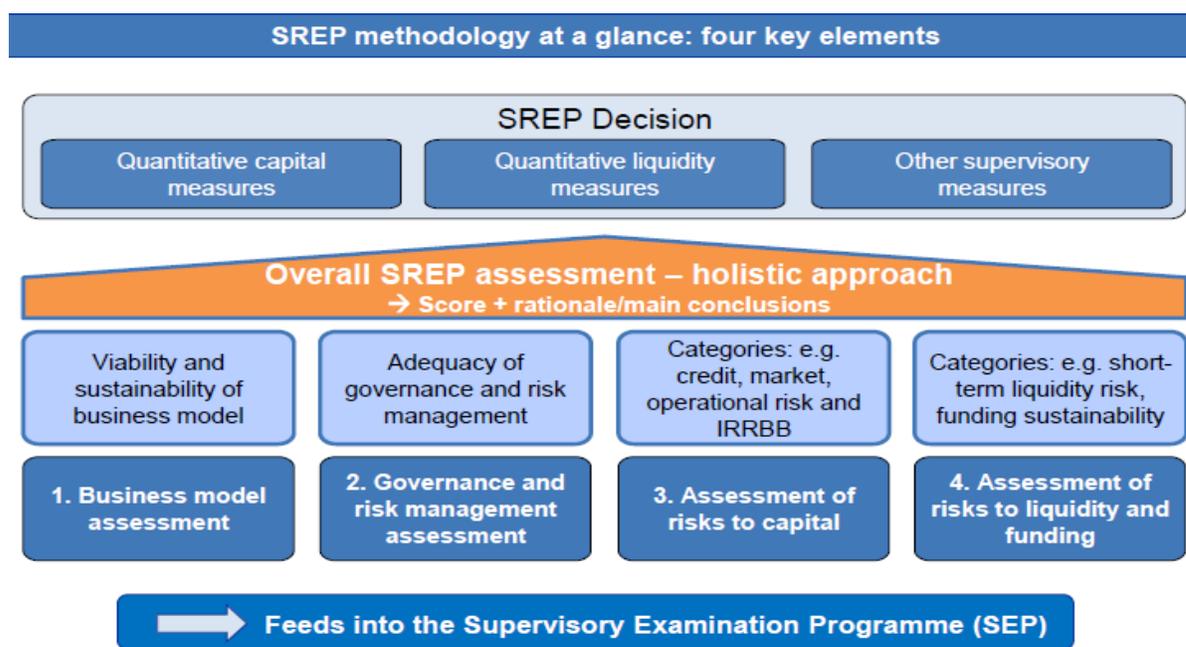
22. **Establishing a more delineated repartition of tasks and responsibilities between off-site and on-site activities is needed for an effective SRP framework.** The organization of a coherent full-scale supervisory cycle should be put into perspective (i.e., individual bank risk profiling, formal annual SRP decisions, determination of supervisory priorities and preparation of the supervisory program, integration of the SRP with enforcement processes and escalation procedures). To improve the effectiveness of supervisory processes, it will be very important for the CBJ to minimize time-consuming non-risk related tasks and find the right balance between the offsite and onsite functions to ensure a continuous monitoring of banks' risks and more risk-focused and targeted onsite missions,

23. **It is recommended that the SRP approach is kept simple in its first version, proportionate to the size and main risks of the Jordanian banking sector as well as to the CBJ resources,** while leveraging as far as possible on existing reporting and tools, but also reinforcing data availability and formalizing guidelines for risk analysis. Integration of stress testing results and ICAAP analysis can also help achieve the forward-looking element of the SRP assessment. The CBJ should also aim to design a matrix to establish link between the main SRP scoring and a range of capital add-on to the minimal Pillar one capital requirements.

24. **The SRP approach should be implemented progressively based on prioritization of main risks building blocks**, according to the most prevalent risks in the Jordanian banking system. When a first version of the SRP is already designed, calibrated and tested, other types of risks (i.e. IRRBB, Cyber security, AML, etc.) could be added to the existing scheme. Establishing a first workable SRP system within a reasonable timeframe is already a challenge given the current resources allocation in the Banking Supervision Department, as well as the current data limitation.

25. **The common SRP framework can be built on the four following main blocks:**

- Business model and profitability analysis.
- Assessment of internal governance arrangements and institution-wide controls.
- Assessment of risks to capital and adequacy of capital to cover credit and operational risks at first stage and incorporating other risks including IRRBB and market risks at a later stage.
- Assessment of risks to liquidity and adequacy of liquidity resources to cover these risks.



Potential SSM-like SREP approach blueprint

26. **The specific elements of the SRP framework can be assessed and scored on a scale of 1 to 4.** The outcome of the assessments forms the basis for the overall SRP assessment, which represents the up-to-date supervisory view of the institution’s overall viability. It should also form the basis for supervisory measures and dialogue with the individual banks.

27. **The CBJ can optimize workload allocation by applying proportionality.** This can be achieved through categorizing the banks into four distinct categories (e.g., based on their systemic importance and their cross-border activities) and developing a minimum supervisory engagement model (frequency and intensity of assessment) based on the category of the institution, as well as on its SRP score.

28. **Key indicators monitoring should rely on a fully-fledged supervisory database.** As data requirements are key to establish a sound risk-based supervision, all existing data sources available to CBJ (stemming from regulatory reporting, financial statements, banks' ad-hoc reports, etc.) should be compiled and assessed in a single supervisory database allowing i) availability of data sets for risk-assessment purposes (i.e. not only point-in time but also through-the cycle analysis), ii) building up of statistical historical perspective, iii) eliminating time consuming steps of compiling different types of data sources (soft and hard copies, various formats like PDF, XL, CVS). This medium-term project could call for in-house or external IT support.

29. **The mission also noted that special attention should be given to the Islamic banks within the Jordanian banking system in the SRP process.** Islamic banking represents between 11.4 percent of the national domestic banking system in terms of assets. SRP process should also run in parallel for Islamic Banks based on the same global methodology while taking into consideration their characteristics and ownership structure (some domestic Islamic banks are subsidiaries of larger domestic traditional banks).

30. **It is proposed by the mission that the Roadmap to SRP implementation follows the steps described below:**

TABLE 1. Principal Recommendations: A Three-Step Roadmap to SRP

| Recommendations | Priority | Time Frame ¹ |
|--|----------|-------------------------|
| Step 1: Design Phase => Overall SRP Architecture and Building Elements | | |
| Formalize overarching objectives of the SRP approach within the risk-based supervision system as intended by CBJ. | High | ST |
| Deliverable: High level intention note validated by CBJ's Senior Management | | |
| Categorization of banks to four categories based on their systemic significance (size, complexity, cross border operations, etc.). According to the categorization of banks, define the application of the principle of proportionality to determine the supervisory intensity (Minimum Engagement Level). | High | ST |
| Deliverable: Categorization of banks to determine supervisory intensity | | |
| Define the overall architecture of SRP and its main elements (main blocks of risks, potential weighting for each block and sub-scores, interaction matrices for inherent risk level and risk control, coherence with actual prudential risks cartography, links to minimum capital requirements ranges/brackets, etc.) | High | ST |
| Deliverable: High-level SRP architecture and principles | | |
| Specify which risks' blocks will be included in the first version of the SRP (<u>proposal</u> : Business model and profitability, Governance and Internal Control, | High | ST |

¹ ST: In the short term, less than 12 months.

MT: In the medium term, 12 to 24 months.

LT: In the long term, 24 to 36 months

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| <p>Risks to Capital: Credit risk and operational risk, Risks to Liquidity). To include additional risks to capital (e.g., IRRBB and market risk) in the second version of SRP.</p> | | |
| <p>Deliverable: Validation of the risks' blocks for the first version of the SRP</p> | | |
| Select the main key risk indicators KRIs | High | ST |
| <p>Deliverable: List of KRIs to be monitored</p> | | |
| Identify the gaps in raw quantitative data needed to regularly compile, store and calculate all KRIs required for SRP analysis (financial data, prudential data, market and/or external data, etc.). | High | ST/MT |
| <p>Require the needed information through regulation addressed to banks</p> <p>Evaluate needs of possible external or in-house IT assistance in developing the prudential database and automatic compilation of KRIs.</p> | | |
| <p>Deliverable: Assessment of data gaps</p> | | |
| Draft the first version of the questionnaires for the qualitative assessment of the various risks' blocks. | High | ST/MT |
| <p>Deliverable: First drafts of qualitative questionnaires</p> | | |
| Define the minimum documentation package required from banks on a regular basis for the purposes of SRP analysis (i.e., financial statements, external auditor's reports, internal auditors' reports, yearly strategic, budget and business plans, risk appetite framework, assessment of quality of internal control framework, Board and executive committees' transcripts, etc.). | High | ST |
| <p>Deliverable: List of minimum supervisory documentation package.</p> | | |
| <p>STEP 2: Conception Phase => Risk Blocks and Calibration</p> | | |
| Review the first draft of selected KRIs and qualitative questionnaires for the various risks' blocks (i.e., Business model and strategy, Governance and internal control, Risks to Capital, Risks to liquidity). | High | ST/MT |
| <p>Based on the availability and robustness of data, propose first draft of scoring calibration for quantitative indicators.</p> | | |
| <p>Deliverable: Final components of main risk blocks. (Optional: scoring calibration attached to KRIs).</p> | | |
| Test different weightings proposals for building blocks and sub-risks categories, to result in a global SRP score. | High | ST |
| <p>Deliverable: Validation of the score weighting approach.</p> | | |

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| Follow up on the progress of the IT development project for the Supervisory Database Deliverable: Submit user requirements on the Supervisory Database to the IT developer. | High | MT |
| Ensure that responsibilities between offsite and onsite functions for the implementation of the SRP approach are clearly defined and well-articulated, and revise the organization of the Banking Supervision Department organization accordingly, where necessary. Deliverable: Potential proposal to CBJ senior management on BSD organization | High | MT |
| Consider proposals to address AML/CFT analysis outside or within the first phase of the SRP framework. Deliverable: Decision on AML/CFT integration within SRP first phase | High | MT |
| Review and update the ICAAP evaluation guidelines to be integrated within the SRP approach. | Medium | MT |
| Review and update the stress-testing framework to be integrated within the SRP approach. | Medium | MT |
| Propose draft Regulation on IRRBB, to integrate this risk under element Risk to Capital in the SRP approach. | Medium | MT |
| STEP 3: Testing and Implementation Phase | | |
| Finalize calibration of KRIs scoring according to latest available data sets, and assess potential differences with previous calibration results. | High | LT |
| Draft Examiner SRP Guidance Manual to provide detailed guidelines for implementing the risk assessment in SRP to help supervisors judge properly the different risks and their scoring. | High | LT |
| Evaluation of the robustness and adequacy of the SRP through dry runs on a sample of banks with different risk profiles. Fine-tune methodology according to results. | High | LT |
| Propose a framework linking the SRP scores to ranges of additional capital and liquidity. | High | LT |
| Propose a progressive implementation timeline of the SRP approach according to resources and banks' state of preparedness. | Medium | LT |

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| Check gradual integration of SRP process into IT architecture for automatization of the most important/time consuming steps on data compilation. | High | LT |
| Organize training for supervisors on the objectives and implementation of the SRP approach. Focus on practical hands-on interactive workshops through concrete examples. | High | LT |
| Organize training and awareness-raising sessions for banks regarding the new SRP approach at the managerial level and at the operational level for data input and compilation. | Medium | LT |

Appendix. Regular Reports Submitted by Banks Through the Off-site Supervision System (OSS)

| # | Risk | Category | Frequency | Data Type |
|---|--|---|-----------------------------------|-----------------------------------|
| 1 | Various risks | Financial sounds indicators | Quarterly | OSS system |
| 2 | Various risks | Financial statements of banks | Quarterly, Semiannual, Annual | OSS System, and Hardcopy. |
| 3 | Credit risk, Problem assets, provisions | Detailed data about the exposure and provisions according to ifrs9 and to CBJ instructions no. (47/2009). | Semiannual, Annual. | By email (Excel) |
| 4 | Large exposures risk and related parties | Large exposures reports | Monthly | OSS system |
| 5 | Liquidity risk | Liquidity: Legal Liquidity. Liquidity Coverage Ratio (LCR). Maturity Ladder | Daily Monthly Quarterly | OSS system, and by email (Excel). |
| 6 | Regulatory capital adequacy | | Quarterly | Hardcopy |
| 7 | Various risk | Managing Assets-Liabilities in Foreign Currencies, and granting credit in foreign currency Banks' ownership of stocks and capital shares in Companies. | Monthly Quarterly | OSS system and Hardcopy. |
| 8 | Pillar II | ICAAP report | Annual | Hardcopy |