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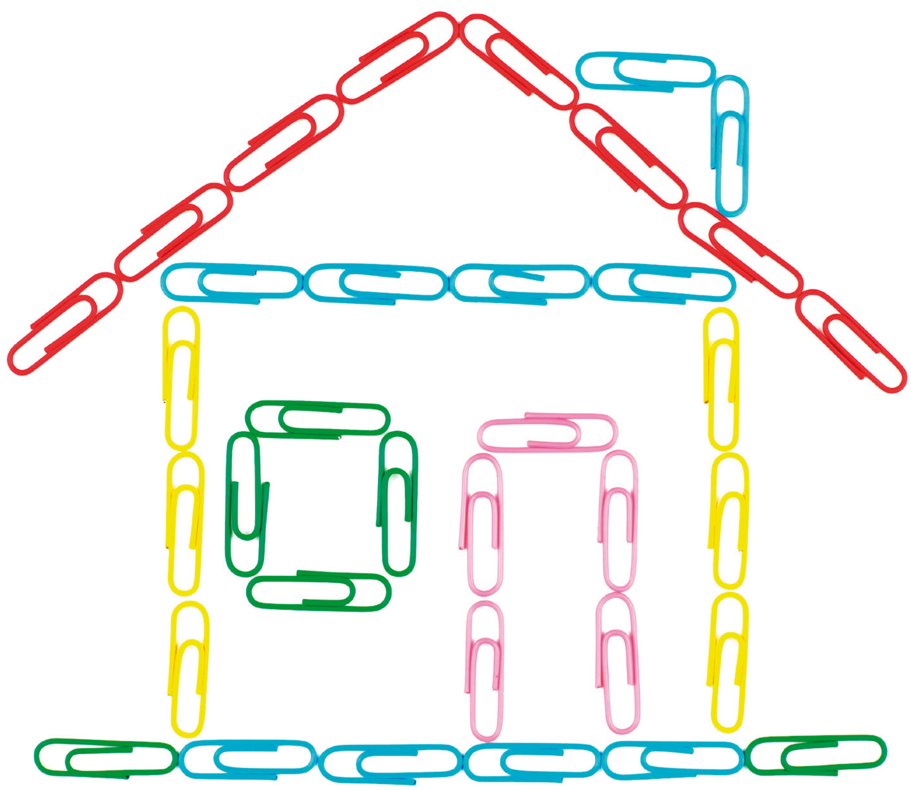
The Single Supervisory Mechanism (SSM)

Banking on the Banking Union



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Contents

The Eurozone is now only a few months away from completing a decisive step "towards a genuine economic and monetary union", as was set out in the summer of 2012[1]. Although at times it seemed unlikely to be achieved, agreement has now been reached on all pillars of the Banking Union.

The Single Supervisory Mechanism (SSM) is rapidly becoming a reality and will take over prudential supervision of banks in the Eurozone from November this year. At the European Parliament's mid-April plenary session, a harmonised resolution regime and a Single Resolution Mechanism (SRM) were agreed; negotiations on harmonised rules for deposit guarantee schemes across the EU were concluded too. The EU Single Rulebook in other areas is also being developed at full throttle.

There remains a significant amount of detail still to emerge. How operational arrangements will work in practice is yet to be seen; important technical standards related to the resolution framework need to be developed. But the scope of the changes and the speed with which they will be implemented are such that banks do not have the luxury of time to wait for the details to be clarified before they need to prepare.

Of course, supervisors have already engaged with banks, particularly through the European Central Bank's (ECB) comprehensive assessment exercise. This on-going work, combined with the legislation that establishes the Banking Union and an understanding of the Banking Union's objectives more broadly, provides sufficient insight to allow banks to begin to put the pieces of the Banking Union puzzle together. Banks need to plan carefully – from effectively engaging with key decision makers, through meeting the new supervisory expectations, to understanding their implications for business practices and models. Not everything needs to be ready for the start of the SSM in November, but significant progress needs to have been made.

This paper provides a view on the key Banking Union 'puzzle pieces'. It captures developments over the past six months, building on Deloitte's September 2013 publication, *SSM | Stronger Together?*[2], which detailed the key features and challenges of the SSM. The paper looks back at the original ambitions of the Banking Union and how they have been met and assesses how the agreed changes fit together.

We put forward three questions that banks should begin to address without delay:

1. **How are regulatory relationships going to change?** Banks place a lot of reliance on long-established and multi-dimensional relationships with their current supervisors. New relationships need to be established with SSM supervisors, many of whom are only now being appointed.

2. **How will changes to the supervisory approach, and in turn supervisory decisions, affect banks?** What decisions, for example, on waivers or partial exemptions, are most critical? How will the Supervisory Review and Evaluation Process (SREP) evolve? Will banks need to alter their own process and procedures for addressing prudential issues?

3. **What are the implications of the changing resolution process?** How will changes to resolution arrangements affect resolution planning and resolvability assessments? Will there be any spillover effect over and above what banks might otherwise expect, for example, to the cost of capital?

The paper tackles these questions in turn, after a brief look at the state of play on establishing the Banking Union. Our analysis draws on our experiences across the Eurozone, helping banks and regulators to understand and work through the challenges.

Management of these changes needs to be led by senior management and considered alongside other regulatory change projects, such as recovery and resolution more generally, the revised Capital Requirements Directive and Regulation (CRD IV), and requirements for banking structural reform. All of these underline, yet again, the importance of a strategic approach to regulation, and its pervasive impact on the business models and economics of banking, not only in the Eurozone but more generally.

1 *Towards a Genuine Economic and Monetary Union*, Report by the President of the European Council, 26 June 2012

2 http://www.deloitte.com/assets/Dcom-Spain/Local%20Assets/Documents/Industrias/FSI/es_fsi_ssm_stronger_together_031013.pdf

The State of Play

Where it all started: the Banking Union objectives

The Banking Union project originated from the 'never-again' attitude that Eurozone decision makers adopted in the wake of the financial and sovereign crises. The project's scale, scope and timelines were ambitious from the start, capitalising on a strong political will to safeguard financial market stability and discipline. Since the original commitment in 2012, deadlines have slipped and resolve on some issues, for example the creation of a common deposit guarantee scheme for the Eurozone, has weakened. Yet, the shape of the Banking Union continues to be moulded by the promises national leaders made at the onset of the project.

These objectives link directly to changes the Banking Union introduces, and as such are essential to understand. They can be particularly helpful in interpreting how the Banking Union, and the SSM within it, is likely to evolve and what the detailed framework will look like in practice.

Table 1. The Banking Union objectives

Objective[3]	Means to achieving it
1: Complete the Eurozone integrated financial framework and enable Europe to address in a united way the structural shortcomings in its institutional framework which the crisis revealed.	• By elevating responsibility to the ECB, the SSM is intended to ensure consistency and efficiency of supervision across the Eurozone. • Similarly, establishing a single resolution authority will standardise resolution planning and procedures for all cross-border banks in the Eurozone, not just the Global Systemically Important Banks. In the process, it is intended to ensure a more efficient and impartial decision-making process. • Progress on the Single Rulebook is clearly driven by this commitment too (although the rules will apply to the whole of the EU). • Market integration will be further improved if these measures make banking markets more competitive.
2: Break the "vicious circle" between banks and sovereign. 3: Build a capability that allows country-specific shocks to be absorbed.	• To break the bank-sovereign nexus, the Banking Union will look to ensure that the cost of bank failure is borne first and foremost by the private sector, with capital from the sovereign used as a last resort. The introduction of the bail-in tool under the Bank Recovery and Resolution Directive (RRD) is a key step towards this goal. • The creation of a single, privately funded resolution fund, with the ability to borrow, will create a financial cushion different from the public purse. • Once resources in the fund are fully mutualised, the cost of resolution will be shared across the Eurozone, thus facilitating the absorption of country-specific shocks, while also helping to reduce the bank-sovereign link at the national level. • SSM is also intended to reduce the probability of bank failures and the need for public funding. That is why the new supervisor needed to have pre-emptive intervention powers applicable to all banks, while its direct involvement will depend on the size and nature of the bank's business. • Having an integrated Eurozone prudential supervisor, i.e. the SSM, was set as a pre-condition for the European Stability Mechanism (ESM) to recapitalise banks directly.

These objectives can be particularly helpful in interpreting how the Banking Union, and the SSM within it, is likely to evolve and what the detailed framework will look like in practice.

3 Towards a Genuine Economic and Monetary Union, Report by the President of the European Council, 5 December 2012

Where is Banking Union now? The state of play

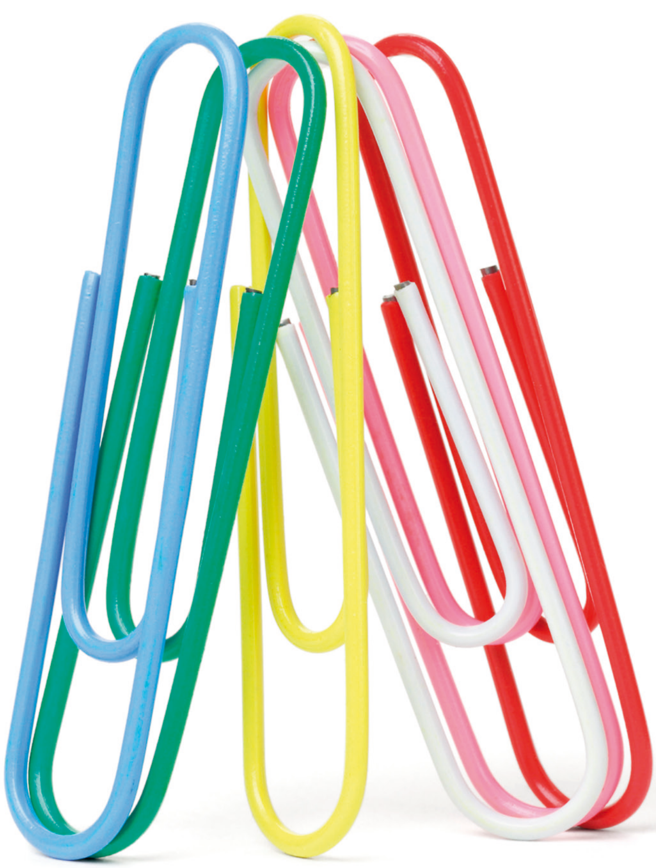
There is now significant clarity around the timelines of all Banking Union pillars:

- The regulation establishing the SSM was agreed in December 2013. The operationalisation of the new supervisor is nearing completion and it is scheduled to open its doors fully in November 2014. Important preparations, including a comprehensive assessment of the banks the ECB will supervise directly, are well under way.

- Despite heated debates and concerns over slipping timelines, the Eurozone will also advance towards a harmonised resolution regime through the RRD and the SRM. The Single Resolution Board (SRB) within the SRM is to become fully operational by January 2015, while the Single Resolution Fund (SRF) will be built up between 2015 and 2024. The RRD needs to be implemented by January 2016.

- Finally, the Deposit Guarantees Schemes Directive (DGSD) will reduce divergence in such schemes throughout the EU, with Member States given until January 2016 to implement the new rules. Both the DGSD and the RRD are part of the EU's commitment to a Single Banking Rulebook, towards which the European Supervisory Authorities have been developing standards and guidelines. The Single Rulebook is thus also an integral part of an integrated Banking Union as well as the wider EU Single Market.

Taken together, these legislative and institutional developments paint a more-or-less complete picture of the Banking Union, and set out the broad shape of the prudential regime for banking services, from the point of authorisation to the (possible) point of resolution.



The Banking Union at a glance: from authorisation to resolution

- European Central Bank (ECB)
- National Competent Authority (NCA)
- Joint ECB-NCA team
- National Designated Authority (NDA)
- Single Resolution Board (SRB): Executive Session
- Single Resolution Board: Plenary
- EU Commission or Council
- Credit Institution (CI)

Figure 1. Authorisation

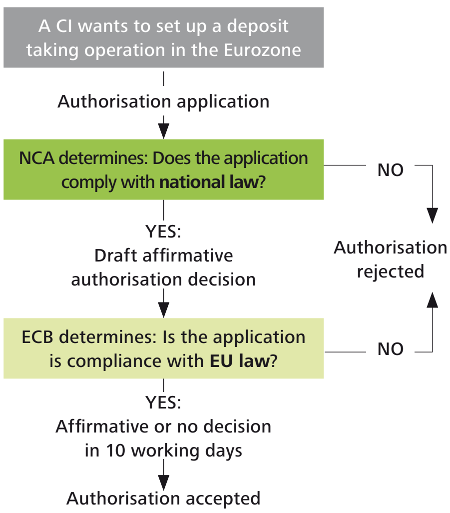


Figure 2. Classification

1 Initial assessment of whether a CI is 'significant' or 'less significant'

Institutions that satisfy any of the following criteria will be designated as 'significant':

1. **Size:** Assets in excess of EUR 30 billion. Assets to be determined on the basis of year-end prudential consolidated reporting
2. **National Importance:** Assets represent more than 20% of the respective country's GDP and in excess of EUR 5 billion
3. **Significance of cross-border activities:** Ratio of cross border assets to total assets is above 20% or the ratio of cross border liabilities to total liabilities is above 20%, and total assets exceed EUR 5 billion
4. **Recipient of public funds:** The CI has applied for and received public funding via the EFSF or ESM
5. **Top 3 Significance:** The CI is one of the three most significant CIs in a MS. The ranking shall be done on the same basis as for the size criterion

2 ECB decision to directly supervise a 'less significant' bank

- The ECB may decide at any time to exercise directly supervise a less significant CI in order to ensure **"consistent application of high supervisory standards"**
- It will take into account:
  - If the CI is close to meeting one of the 'significant' criteria
  - the interconnectedness of the less significant CI with other credit institutions
  - Whether the relevant NCA has followed ECB instructions and complied with the SSM Regulation
  - If the CI has requested or indirectly received financial assistance from ESFS and ESM
- An NCA may request the ECB to exercise direct supervision
- If there is an exceptional substantial change in circumstances relevant to the SSM 'significant' criteria, e.g. a merger

3 Continuous assessment of whether a bank is 'significant'

A bank ceases to be 'significant; if:

- None of the significant CI criteria are met for three consecutive years
- If financial assistance was requested, but denied, fully returned or terminated and three years have elapsed after return or termination
- ECB issues a supervisory decision assigning a less significant CI classification to a significant CI

Figure 4. Macroprudential supervision

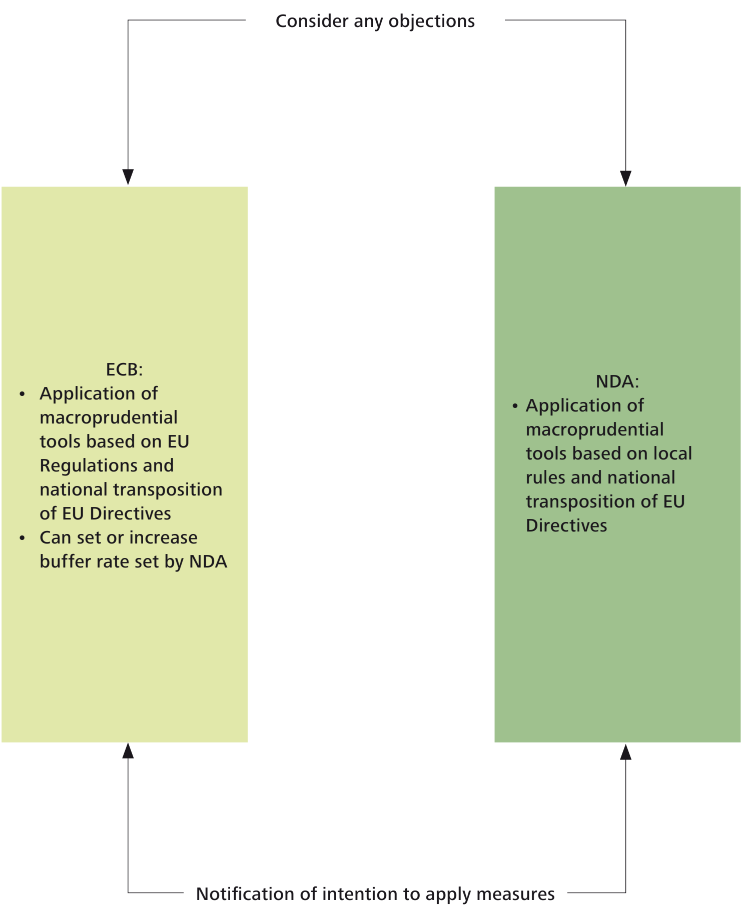


Figure 5. Recovery and Resolution

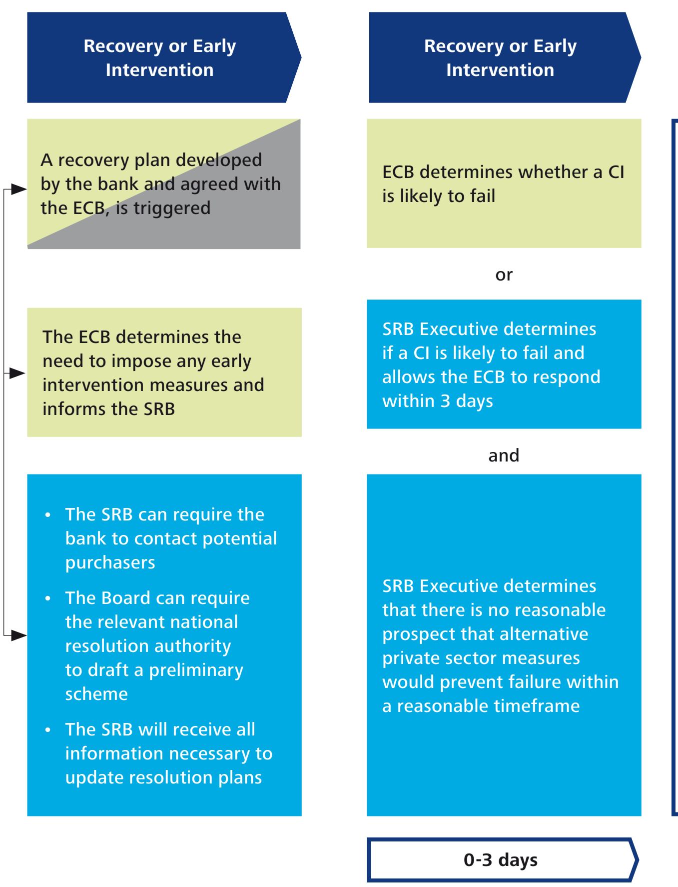
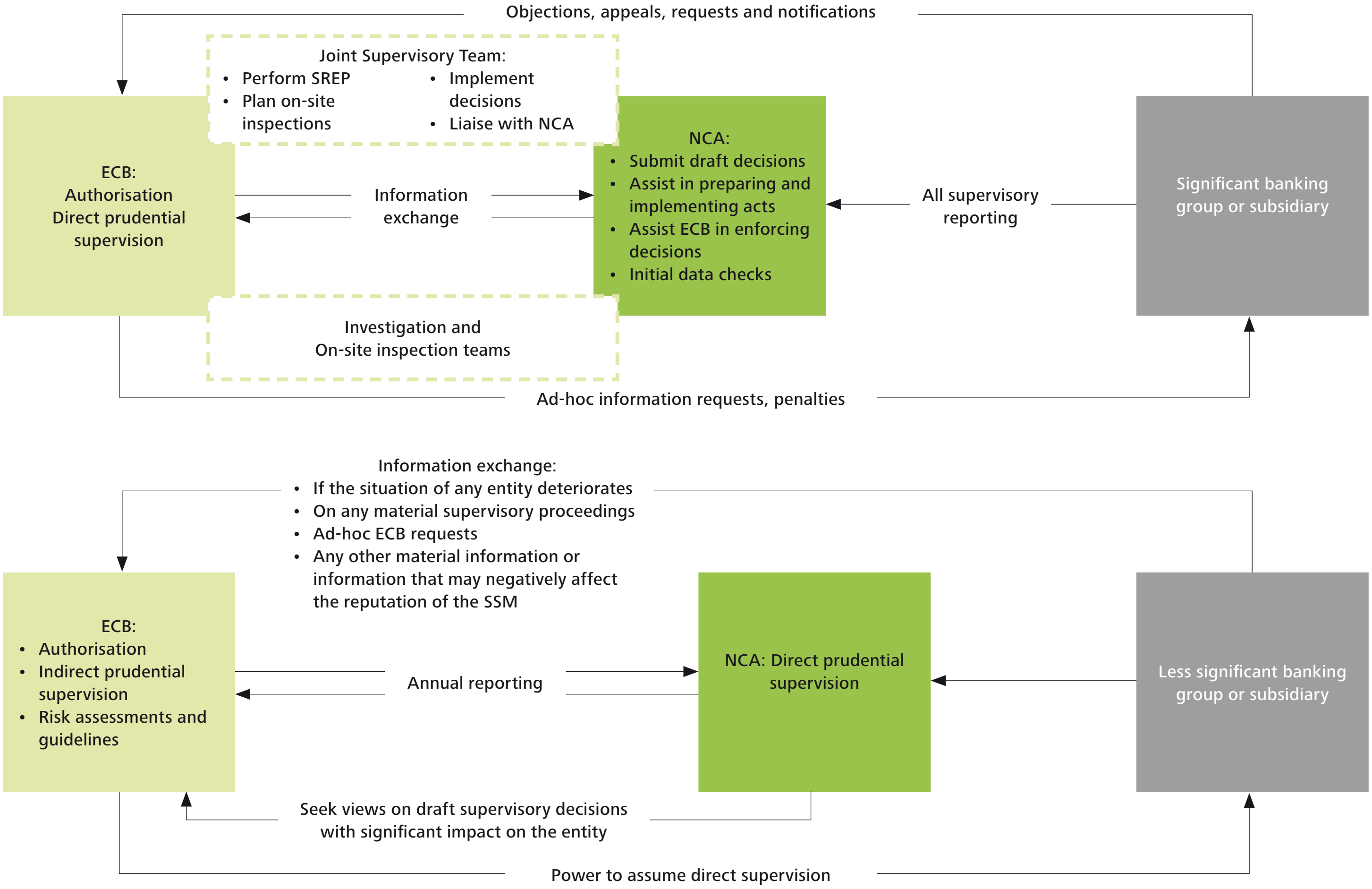
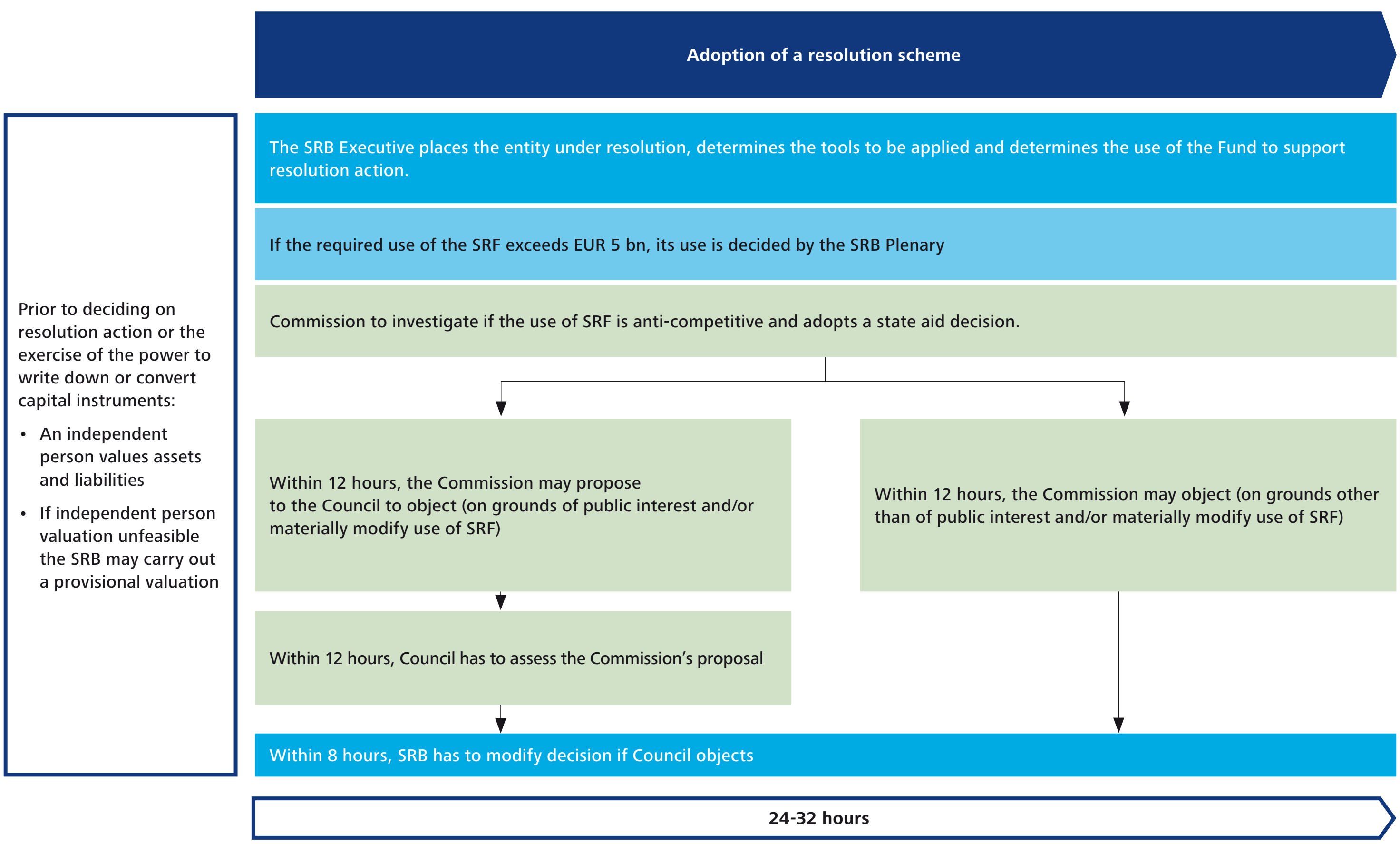


Figure 3. Microprudential supervision





How will supervisory relationships change?

The SSM will require banks to engage with a new set of supervisors and respond to new supervisory techniques and expectations. It will also modify the roles and responsibilities of the national supervisors banks have dealt with thus far. The implications of this change are significant. Banks need to adapt to this landscape across their Eurozone operations.

The new kids on the supervisory block

Supervision under the SSM will be organised in four newly-formed Directorates General (DGs) located in the ECB. Banks classified as 'significant' will be assigned to either DG I or DG II. It is still unclear exactly how this division will be made, but we expect balance sheet size to be a key consideration. Supervisors from either DG, along with national supervisors, will then form so-called Joint Supervisory Teams (JSTs). The JSTs are the operational units of the SSM, with regard to direct supervision of 'significant' banks. They are tasked with all day-to-day supervisory responsibilities conferred on the ECB, such as supervisory risk assessment, monitoring and challenging governance arrangements, and coordinating on-site inspections.

Even for banks directly supervised by the ECB the role of national competent authorities (NCAs) remains vital. NCAs will assist with the preparation and implementation of supervisory decisions. NCAs can, and, in the short term in particular may well, propose draft decisions on their own initiative. NCAs will also remain the first point of contact for all supervisory reporting.

DG III will be tasked with oversight of the banks classified as 'less significant'. It will look to identify supervisory weaknesses and risks posed by these banks and conduct thematic analyses of specific risk areas. It can recommend that the ECB takes over direct supervision of any 'less significant' bank from the NCA, but will not have direct supervisory responsibilities itself.

The fourth, 'horizontal', DG is a key element of the SSM architecture. It is tasked with a number of specialised functions, including developing supervisory methodologies, coordinating on-site inspections, contributing to internal model validation, and developing recovery plans, ensuring their comparability across the Eurozone. DG IV will also conduct SSM-wide risk analyses and oversee consistency of supervisory decision-making across both 'significant' and 'less significant' banks. These wide responsibilities make DG IV a powerful policy directorate and the in-house architect of the SSM supervisory approach.

The Director Generals who head up these Directorates will report to the Chair of the SSM, who in turn, will report to the SSM Supervisory Board, the principal decision-making body of the SSM. Finally, the Supervisory Board's decisions need to be approved by the Governing Council of the ECB, which has the power to object to them.

Given the frequency with which banks typically engage with their supervisors and the importance that should be placed on having cooperative and effective supervisory relationships, the new arrangements will have key implications for banks' day-to-day operations and broader strategic considerations.

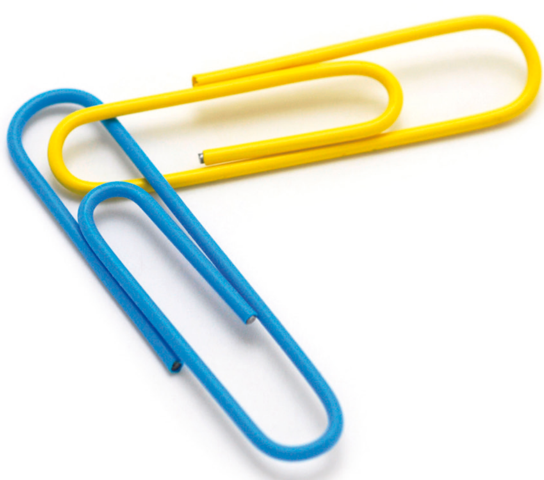
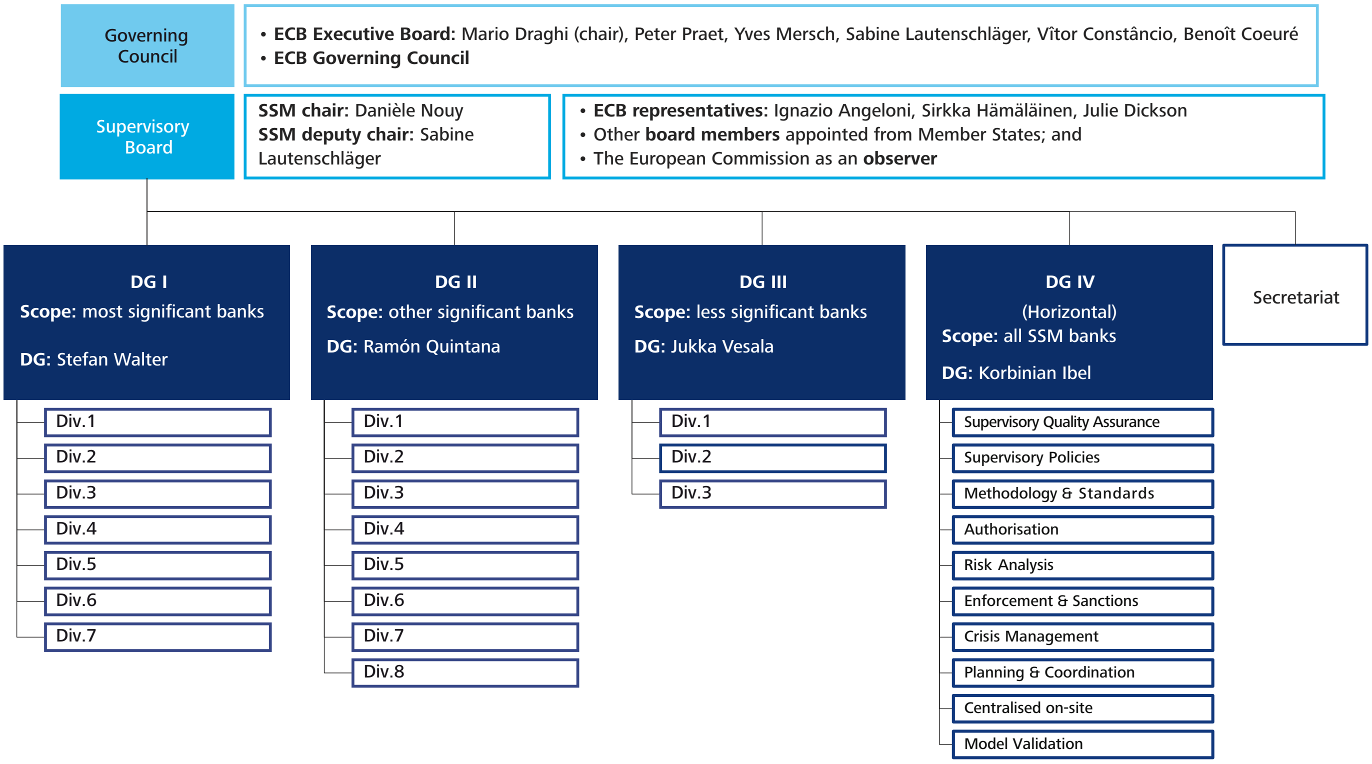


Figure 6. SSM Organogram



Source: EMEA Centre for Regulatory Strategy

Adjusting to the new supervisory landscape

How should banks' senior management and regulatory affairs functions adapt to the new supervisory architecture? The organisational blueprint of the SSM, key appointments and published operational details should give banks an idea of how the system will work, but how the blueprint is executed is still subject to uncertainty. For instance, which 'significant' banks will be supervised under DG I and which ones under DG II? Which individuals will be part of a bank's JST? While the answers to some of these questions are imminent, the actual transfer of responsibilities between NCAs and the ECB will be a lengthy and not straightforward transition, for which banks need to prepare.

To that end, banks will also have to take a view on how and when their relationship with local supervisors may change. Eventually, the roles of NCAs and local resolution authorities will change and reduce in prominence, but certainly not disappear. A further consequence is that supervisory relationships will change as some local supervisors move to Frankfurt. And while NCA policy functions will become less active, as those responsibilities will be transferred to the ECB's DG IV, some will still be needed, for example for advising national representatives on the ECB Supervisory Board, transposing EU Directives into national law, and for adopting guidelines and standards issued by the ECB or the European Banking Authority (EBA). The transfer of power between NCAs and the ECB will not happen overnight, and a bank's strategy for supervisory engagement needs to be flexible enough to accommodate this transitional phase.

Building supervisory relationships should be done in a planned and coordinated way. While the decision is not entirely theirs, banks need to reconsider who in their organisations is best placed to engage with supervisors at various levels of seniority, and with what frequency. As the SSM assimilates supervisors and supervisory approaches from across the Eurozone, banks could find that pockets of knowledge sit across their entities. Forming an aggregate view and a coordinated strategy is key. Ultimately, banks will need to decide what degree of centralisation of functions such as compliance or risk and regulatory affairs is most suitable for their structures, and the reporting arrangements needed to support it.

These changes also give banks an opportunity to refocus their approach to supervisory engagement more broadly and consider which of their current practices have proved effective and which can be improved. Some aspects may have evolved historically but not necessarily be the most effective or efficient approach, not least in terms of internal coordination. These changes allow such legacy issues to be addressed. Based on our experience, there are a number of good practices banks can follow.

Understanding the objectives, lines of accountability, and, more broadly speaking the 'language' of the supervisor, is vital for forming a better view of how supervisory expectations translate into practice, as well as where and how they might align with the bank's own objectives. And banks need to closely monitor how the approach of the new authorities evolves and pro-actively form a view of what aspects of their business could become a source of concern.

Finally, banks need to consider the non-Eurozone dimensions of the ECB's work. The ECB, acting as both home and host supervisor of all 'significant' banking groups and their Eurozone operations, will participate in supervisory colleges and Crisis Management Groups with supervisors from outside the Eurozone. It will also engage with regional authorities, such as the EBA, and international standard setters, such as the Basel Committee on Banking Supervision. By expressing a single Eurozone view, the ECB may alter the negotiation dynamics that have existed before. This strengthens the case for establishing strong relationships with the ECB as soon as possible.

How will the supervisory approach change?

There remains a significant amount of uncertainty about how the ECB supervisory approach will feel in practice. In the medium-term, will it be radical or evolutionary? Will the ECB adopt a consensual approach or a more risk-averse and conservative line? How will its operational structure affect day-to-day supervision? Will the new approach differ significantly from national practices and, if so, from which ones?

Statements made by members of the ECB executive provide some insights. We know the ambition of the SSM is to "identify and implement the best supervisory practices as well as to be ambitious and innovative".[4] At the same time," … two conditions have to be fulfilled. First, there needs to be a single set of rules. Second, if those rules contain any discretion, there needs to be a central authority that can enforce them evenly." [5] In this context, "it will be particularly important to strike the right balance between ensuring fair competition by treating the same risks equally and, at the same time, allowing for varying market and banking structures as far as these cater for the heterogeneous needs of the real economy."[6]

Some clarity on the operationalisation of the SSM was provided by the Framework Regulation, which specifies how the ECB will cooperate with NCAs in the supervision of both 'significant' and 'less significant' banks. Further detail on the ECB's approach to supervision, importantly on the way it will conduct a SREP, will be published in its Supervisory Manual. This document has not been shared publicly yet. The Supervision Manual will have some parallels with an EU-wide Supervisory Handbook which the EBA is also preparing currently, though how the two documents will complement each other is at this stage unclear.

In the short term, the new supervisor is likely to rely on the knowledge and established practices of national supervisors.

Looking beyond the public statements and documents, **it will take time for the ECB's supervisory approach to take a tangible shape**. In the short term, the new supervisor is likely to rely on the knowledge and established practices of national supervisors. The ECB will want to involve NCAs significantly and draw on the information accumulated locally. At the onset of its work, the ECB may be more cautious about the risks involved in applying a new supervisory approach and about opening itself up to tensions with national practices. Thus, the ECB's early stage decision-making may not feel new to firms, though they would be wise not to draw too much comfort from this.

Even from the start, however, **the new arrangements may feel more cumbersome**. NCAs will have to bring their new colleagues and superiors up to speed with the background to any decision regarding a 'significant' bank and any important decisions regarding a 'less significant' bank. The thresholds for information escalation are purposefully vague in the SSM Regulations. Those thresholds need to be set and they are likely to be low at first, as the SSM is under pressure to be vigilant and avoid mistakes in its early days. Additionally, the lines of responsibility between NCAs and the ECB will inevitably be less clear initially. Even though the ultimate decision-making power, for 'significant' banks, sits with the ECB, NCAs can, and some probably will, continue to suggest supervisory decisions, with the risk that some banks may find themselves subject to two separate regimes, rather than one integrated supervisory approach. Finally, the interactions between the JSTs, and between the vertical and horizontal DGs of the SSM, will also need to be fleshed out and may cause delays in decision-making at first.

Through time, any deficiencies in information exchange, knowledge or division of responsibilities will be sorted out. **This evolution, however, will come with characteristics typical of more centralised decision-making**. The ECB will want to ensure that supervision across its DGs and supervisory teams is consistent, and therefore its supervisors are likely to rely on data, top-down guidelines and centralised internal processes. Their decisions may be more risk-averse and less tailored to a specific bank's context, as a result. The chain of reporting, briefing, and information provision, from the local level to the ECB senior leadership, will remain long, both in terms of geography and, perhaps, seniority.

4 Answers by Danièle Nouy to ECON Questionnaire, December 2013

5 *A regime change in supervision and resolution,* Speech by Yves Mersch, September 2013

6 *Supervisors without borders,* Speech by Sabine Lautenschläger, September 2013

Despite the uncertainty, banks can begin to prepare now for any changes in the likely supervisory approach. In anticipation of a new and potentially more cautious supervisor, banks should revisit any areas of concern or deficiencies they are aware of internally and plan to address them in a timely and demonstrable way.

In time, the ECB will also want to deliver on its objective to **harmonise the supervisory approach across the Eurozone**. National discretion on transposing EU Directives into national law will remain, but the way the directly applicable EU rules or the local prudential regulations apply will be driven by the ECB. Thus, banks will increasingly feel a difference between the new and the previous supervisor's priorities and expectations, both in terms of how EU rules and regulations are applied and the risks and weaknesses the supervisor focuses on. In addition, the SSM is likely to draw heavily on peer group analysis for the 'significant' banks it supervises, with banks of comparable size and business models finding themselves scrutinized alongside each other. These new capabilities may mean banks facing higher scrutiny than before and may shed new light on risks.

The removal of any latent domestic bias is a significant aspect of what the SSM will strive to achieve. By applying a consistent approach across the region, the SSM will over time eradicate any benefit given currently to particular asset classes or to 'national champions'. It will seek to "lower inclination to develop 'national champions' and, in the case of bank problems, to undertake supervisory forbearance and to delay remedial action".[7] The requirement to have a mix of nationalities in each JST, despite the logistical and linguistic challenges it will create, works directly towards this objective.

Finally, **the supervision of 'less significant' banks will also converge**, albeit more slowly, through the ECB issuing guidance or pointing local supervisors to certain risks.

What will it mean for banks?

The consequences of the ECB's new supervisory approach are clearly significant. The transfer of decision making power away from NCAs will require banks to adapt across the board, from the way they conduct their Internal Capital Adequacy Assessment Process (ICAAP), to how they set up and evidence their risk appetite framework, to how they plan for recovery (resolution planning will also be re-addressed through the SRM).

Being supervised in the new structure and by a new set of supervisors will, at least initially, increase the demand on banks to provide information and contextualise the justification for the present approach, with some scope for unclear messaging and blurred division of responsibilities between the local level and the ECB. Some banks believe there are signs of this already, in the context of the Asset Quality Review (AQR).

Overall, the ECB's data demands will feel new to both banks and NCAs. The ECB Framework Regulation provides some detail for banks to understand the information exchanges between the ECB and NCAs. In particular, local supervisors will need to communicate to the ECB any information of material importance for the stability of the firm – this is true for both 'significant' and 'less significant' banks. This means that banks will need to be able to capture such developments and explain how they will address them. Staying in tune with the ECB's likely demand for data and information may encourage banks to become better at meeting such demands internally.

Despite the uncertainty, banks can begin to prepare now for any changes in the likely supervisory approach. In anticipation of a new and potentially more cautious supervisor, banks should revisit any areas of concern or deficiencies they are aware of internally and plan to address them in a timely and demonstrable way. A supervisory review from a new authority may well highlight issues that current supervisors are aware of, but have deprioritised. If banks are aware of such issues, they should prepare to discuss them and explain how these are being tackled.

More broadly, banks should think about the changes the ECB will be empowered to make in practice. As explained above, the SSM will follow EU rules where those apply directly and national rules where the EU Directives have been transposed. The SSM will exercise discretion, where this is allowed in either EU or national rules. Within this context, what are the significant decisions the supervisor will be making, such as conducting a SREP, asset valuation or assurance over capital reporting for example? While it is not yet clear how the ECB will use its discretion in these instances, banks can prepare an inventory of the changes they may be required to make and build in capacity, both in terms of their human resources, data processes and documentation, and governance structures, to address these.

7 *EU regulatory reforms: some implications.* Presentation by Mauro Grande, Tallinn, Estonia, December 2013

In the longer term, banks should consider how the improved consistency of decision making in the Eurozone can affect their businesses. As the ECB takes over direct supervision, the distinction between home and host supervisor will be removed for 'significant' banking groups and their subsidiaries and branches in the Eurozone. As a result, differences in supervisory approach at group and subsidiary levels should be removed. Convergence in the application of rules raises the prospect of banks being able to achieve synergies from creating cross-border compliance programmes and perhaps also efficiency in reporting. It should also reduce the importance of differences in supervisory approach in determining strategies for restructuring in the Eurozone. Convergence of supervisory practices will also affect the competitive landscape in the Eurozone, as banks of comparable size and business models are subject to similar supervisory expectations.

Finally, some 'less significant' banks may want to consider the likelihood of the ECB taking over their direct supervision. The ECB will have the power to do so if this is necessary to establish a consistent supervisory approach. This power is unlikely to be used lightly – doing so could put the ECB in direct conflict with the NCA from which the 'less significant' bank is being transferred, given the possible suggestion of deficiencies in its supervisory arrangements. In our view, it is more likely that this power would be used when a non-Eurozone headquartered bank has substantial Eurozone presences which do not sit under a single holding company. Under the SSM regulation, the ECB will not be able automatically to consider such a bank's Eurozone footprint in aggregate. The ECB could, however, decide to supervise each of the constituent parts directly, giving it an aggregate view of the group's Eurozone activities.

Filling the gap with conduct of business

The transfer of prudential supervisory responsibilities to the ECB could have a knock-on effect on the way local supervisors approach conduct of business supervision, which will remain the responsibility of NCAs even after prudential responsibilities are ceded to the ECB. As a result, the focus on, and perhaps rigour of, conduct of business supervision may increase. NCAs may, for example, start paying closer attention to the way banks' governance, conflict management, incentives schemes and systems of controls more broadly affect consumer outcomes, in addition to financial stability. The shift could happen fastest (and be more pronounced) in countries with integrated banking supervisors which host both prudential and conduct supervision under one roof, as they reorganise themselves and their agenda in the light of the SSM. For other countries, there may be much less change.

The change in supervisory approach in the Eurozone could also be a trigger for authorities to refocus and reenergise their approach to both prudential and conduct of business supervision. This is certainly so in the UK following the split of the Financial Services Authority (FSA) into the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA). This will give an opportunity to conduct of business supervisors to consider the use of more innovative approaches to data, review and analysis – such as relying on more thematic reviews – or in considering the interaction with competition policy.

Banks will need to stay attuned to how conduct of business is evolving, not only to be compliant in each of the jurisdictions in which they operate, as has always been the case, but also to understand if any changes in approach will affect the cost and attractiveness of doing business in the various Eurozone countries. While harmonising treatment of customers across the EU has been and is an objective of the EBA, other more pressing problems have taken precedence, and therefore national approaches are likely to be the driving consideration for banks, at least in the short to medium term.

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How will the approach to resolution change?

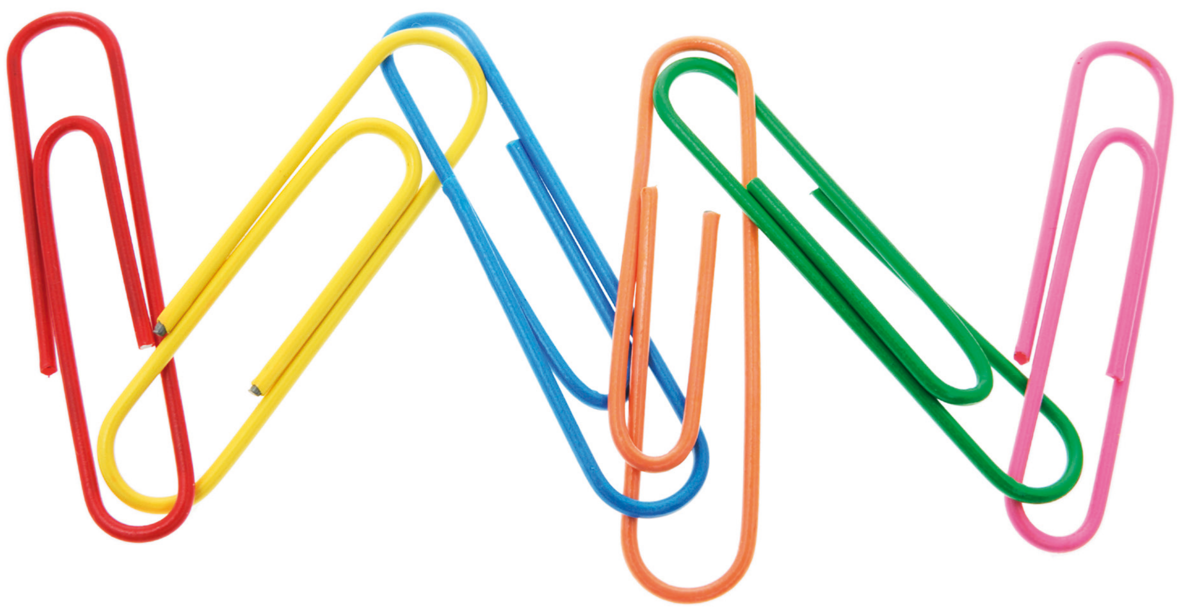
The SRM, in combination with the RRD, constitutes a significant advance towards harmonising and centralising the resolution process in the Eurozone. With decision-making for all cross-border banks in the Eurozone transferred to a single authority, information exchange can be improved and the output of resolution planning be made more efficient. The SRM will be able to ensure consistency and comparability in the treatment of a bank at the group level, and across its Eurozone subsidiaries and branches, in a range of ways: for example in terms of what instruments will qualify for bail-in exemption or how much bail-inable debt a bank should hold across its Eurozone entities. In the absence of the SRM, local supervisors could have taken divergent views on such questions. At the same time, applying the same set of rules across the EU will level the playing field for banks and reduce some of the current barriers to cross-border resolution. It will also become easier for customers, investors, ratings agencies and regulators to build an understanding of, and confidence in, the process.

However, banks and supervisors will first have to endure a complex adjustment period. With the RRD, and the introduction of bail-in from January 2016 in particular, planning for resolution in the EU is becoming a clearer, but potentially more onerous and complex requirement for banks and resolution authorities. At the same time, SRM will require new data sharing capabilities to be built and a significant amount of knowledge sitting with the local resolution authorities to be made available to the SRB. Existing resolution plans may have to be adjusted to meet the expectations of the new authority, given that resolution planning is currently subject to significant national differences.

The financing arrangements that the SRM and RRD put in place with the introduction of bail-in and the SRF should safeguard public expenditure in the event of bank failure, but from a bank's perspective, they will have implications for the cost of capital.

A critical question for the SRM is the mechanics of the resolution process itself. Aligning the interests and considerations of all parties in the SRB, even in its executive session, will be no small task. The SRB is likely to seek to make decisions by consensus even though the SRM Regulation allows for the SRB executive to have the final say, if a compromise cannot be found. These governance and decision-making arrangements are ambitious, and inevitably complex. More decision-makers could mean less decisiveness, or the need for greater compromise.

The SRM will be able to ensure consistency and comparability in the treatment of a bank at the group level, and across its Eurozone subsidiaries and branches, in a range of ways …



Organisation of the SRM

The SRB will take over the role of resolution authority for all banks defined as 'significant' under the SSM Regulation, for any other bank the ECB supervises directly, and for other cross-border banks. It will have certain powers to take over the role of a resolution authority for banks outside this subset, particularly if there are issues with the local resolution body.

The SRB governance structure will be set at two tiers – the Executive and the Plenary. The SRB Executive will be made up of the SRB's Chair and four permanent members. When deliberating on cross-border banks, representatives of the Member States where the group and its Eurozone subsidiaries are situated will also participate in the process. The ECB and the Commission will designate a permanent observer, while observers from the EBA and representatives of non-Eurozone countries where the bank in question may have significant subsidiaries or branches can be invited where relevant.

The Executive will be responsible for nearly all decision making at the SRB, including preparing, assessing and approving resolution plans, determining minimum requirements for own funds and eligible liabilities, applying simplified obligations to certain entities and participating in a resolution procedure, if one is triggered.

Decision-making will be by consensus. If consensus cannot be reached, the four SRB members and the Chair will decide by simple majority. In the case of a tie, the Chair has the casting vote.

The SRB Plenary, comprising of representatives of all participating Member States, the four permanent members of the Board and its Chair, will be responsible for setting the annual programme and budget of the Fund. It will also be asked to make decisions on the use of the SRF if a resolution action is required above EUR 5 billion. In these cases, decisions by the plenary will be taken by a simple majority of the Board members representing at least 30% of contributions. If the net accumulated use of the Fund exceeds EUR 5 billion over 12 months, the Plenary will also be able to evaluate the use of the Fund and provide binding guidance to the executive session.

Acting as the resolution authority for significant and cross-border Eurozone banks, the SRB will participate in any cooperation arrangements with non-participating or non-EU Member States, as set up under the RRD. These include the preparation and assessment of group recovery and resolution plans, removing group barriers to resolvability, and recognition of bail-in. Memoranda of Understanding about these cooperation arrangements will need to be signed. Essentially, the SRB Executive will take over the role of the Resolution College, as the RRD stipulates that any group performing functions similar to a college can assume that role.

The SRM will be in charge of implementing the RRD for the Eurozone banks in its scope, making Eurozone-wide determinations in cases where the RRD leaves scope for discretion to national resolution authorities.

The SRB will have the power to make all decisions currently sitting with resolution authorities or provided for under the RRD. These include:

- adopting resolution plans and carrying out an assessment of resolvability
- adopting measures during early intervention
- waiving the obligations of drafting a resolution plan for certain banks
- setting the level of minimum requirement for own funds and eligible liabilities
- adopting resolution decisions and applying resolution tools
- writing down or converting capital instruments

Implications for banks

As a result of the RRD, resolution planning will no longer be as theoretical an exercise as some might have perceived it thus far. The location and level of loss absorbing capital can affect the ongoing operation and profitability of a business and banks need to understand these effects. The funding costs of banks issuing their wholesale debt near the apex of their group structure as against debt issuance from independent operating entities in different jurisdictions is often seen as a consideration in the choice between the so-called single point of entry (SPE) or multiple point of entry (MPE) resolution strategies (although there are clearly further considerations such as operational and legal entities structure). We expect banking groups to actively model the potential impacts of various legal entities and gone concern loss absorbing capital structures to ensure that appropriate business decisions are made.

The RRD and the focus on bail-in have created a need for banks to have the ability to produce, in a short timeframe, significant amounts of information in respect of the quantum of liabilities eligible for bail-in and the value of assets and liabilities. It is likely that organisations will need significant enhancements to existing processes in order to be able to provide the necessary information in the timeframes required.

We discuss the impact of bail-in on group structure, the new information requirements, implications for operational continuity, and the link between the post-RRD resolvability process and other regulations forcing banks to rethink their group structures in a dedicated paper titled *Recovery and Resolution Directive* | *Putting theory into practice.*[8]

Within the Eurozone, the SRM could improve predictability and consistency in a resolution process. The resolution of any Eurozone entity of a 'significant' bank will be triggered by a single authority – the ECB – and executed by a single authority – the SRB. Host resolution authorities within the Eurozone will no longer be able to take decisions different from the home resolution authority, e.g. decide to resolve a subsidiary domestically. As the de-facto home resolution authority, the SRB will be "supra-national"; any national bias that might have existed in the past and influenced resolution decisions should in principle be removed.

The harmonisation and centralisation of the resolution process could also affect the feasibility of a SPE resolution approach in the Eurozone by improving the scope for coordination between the bank's resolution authorities. While some banks' business and operational models will still favour a MPE approach, there could be an impact on cases where the choice between the two has not been clear-cut. The flipside of the improved cooperation between resolution authorities, however, is that banks may be under pressure to demonstrate better integrated capital and operational arrangements under their resolvability assessments.

Is the sovereign-bank link being broken?

One of the aims of Banking Union was to break the link between (national) sovereign and (local) banks. How far is this objective met by the resolution proposals? A key element in achieving this is to tackle the conditions that drove sovereigns to fund their banks during the crisis.

The introduction of bail-in is a significant step forward, providing for a private-sector solution to a bank's resolution. To provide another cushion between the cost of resolution and the public purse, the RRD requires the setup of a privately-funded resolution fund. All EU Member States will have to set up a fund reaching 1% of either covered deposits (whether total liabilities is a more appropriate basis for calculation is to be determined by the EBA by October 2016) by the end of 2024. In line with this RRD requirement, the SRF will have a target level of 1% of covered deposits, to be reached by January 2024. An extension period of four years in case the Fund makes a cumulative disbursement of 0.5% of total deposits is available under both regulations. At the same time, the DGSD looks to secure depositor protection further across the EU by stipulating that all EU Member States set up an ex-ante funded deposit guarantee scheme, covering all deposits of up to EUR 100,000. And finally, the SRM looks to weaken the link between the sovereign and its banking sector by introducing the so-called mutualisation requirements of the SRF, with funds in the SRF transferred from national compartments to a single compartment over a period of eight years. Should the resources of the SRF need to be used in the interim, drawdown will be made according to a waterfall arrangement, stipulated in an Intergovernmental Agreement (IGA) signed in Council.

The elephant in the room, when it comes to funding the resolution, is whether bail-in and the size of the resolution and deposit guarantee funds will be enough, or whether resorting to public funding in a resolution process remains a possibility. Using the cost of past bail-outs as a yardstick to answer this question, as it is often done, is somewhat speculative. The likelihood that banks would fail in the same way as before is less – or at least that is what the changes to the capital and resolution regimes put in motion since 2008 are aimed at achieving. The assessment is further complicated by the effect of market developments, in particular on the ultimate cost of a resolution, and the likelihood of several banks failing at the same time.

Market dynamics could also have an impact on the efficacy of the break of the sovereign-bank link, if markets chose to take the view that a sovereign would ultimately cover resolution costs irrespective of the private sector solutions provided through the RRD and the SRM. Under that scenario, the weakening of the link would be less marked, and the sovereign would remain at greater risk of the negative feedback resulting from increased debt servicing costs that occurred during the crisis.

Clarity on how this will eventually play out should improve as banks begin implementing the RRD and tackling the challenges of adapting their structures to the new requirements. How efficient and rigorous the SRB is in its assessment of resolution plans and resolvability arrangements can also provide insights into how effective the new Eurozone resolution mechanism will be in the event of a crisis. Ultimately, however, banks should consider what they themselves can do to address the risks from market dynamics in a crisis, when fear of bail-in, or doubts over the actions of the SRM, could be destabilising.

8 http://www.deloitte.com/view/en_GB/uk/industries/financial-services/2a40eb24c7a65410VgnVCM3000003456f70aRCRD.htm

Conclusion

To deliver on the Banking Union objectives, the ECB and SRB will be walking a fine line between being tough and ambitious enough to meet expectations and being realistic in what they can deliver, especially in the short term.

Despite the lengthy political process through which the SSM and SRM, in particular, were agreed, the founding Regulations give the new authorities enough teeth to set the tone for supervision in the Eurozone and to influence and, if necessary, execute resolution plans. These provisions are a significant step towards integrating financial regulation in the Eurozone, which was the Banking Union's first promise. Success in achieving these goals in practice will be more complex. Both the SSM and the SRM will likely seek the consensus and cooperation of national authorities. They will also have to set up and rely on extensive information exchange channels both with other supervisors and with banks. It will take time before these arrangements work smoothly.

Whether and how the new depositor protection and resolution arrangements create sufficient safeguards against a new banking or sovereign crisis is less clear. Certain ties between states and their banking sectors will not be broken – sovereigns remain the providers of the ultimate backstop for the cost of bank failure, to the extent that bail-in proves inadequate. Yet, the SRF will eventually enable the pooling of (some) resolution costs within the Eurozone, and the SRB will seek to ensure that resolution planning takes into consideration the impact on all cross-border operations within the Eurozone. The challenge for the SRM, and the RRD, will be to influence market perceptions of creditworthiness and resolvability before a crisis actually occurs.

To navigate this complex new world, banks need to understand and feed into the Eurozone-level dialogues which the SSM and SRM seek to establish. Banks should consider the possible channels of impact in the context of their own organisation and business model mix. It will also be important to maintain flexibility to react to supervisory decisions and reprioritisation of tasks. Establishing strong and cooperative relationships with the authorities responsible for implementing the rules is key. A bank that fails to engage with this agenda is creating unnecessary risks for itself.

To navigate this complex new world, banks need to understand and feed into the Eurozone-level dialogues which the SSM and SRM seek to establish.

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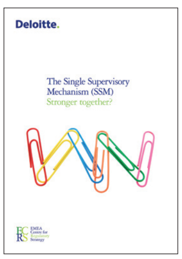
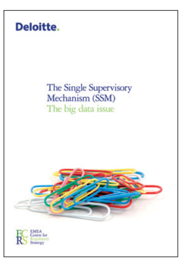


The Single Supervisory Mechanism (SSM):
Stronger together?
This paper explains what the Single Supervisory Mechanism is all about: why it was established, who is in charge and how it will be implemented. It also considers the challenges the ECB and banks face as responsibility for supervision transfers to the SSM.



The Single Supervisory Mechanism (SSM):
The big data issue
This paper is intended to stimulate a debate as to where the ECB in particular might go in tackling the technological solutions and mathematical techniques that could be the differentiating factors in determining whether or not the SSM delivers on the aspirations that have been set.

These and other publications on the Banking Union are available on the Deloitte UK website:

www.deloitte.co.uk/bankingunion

Glossary

AQR: Asset Quality Review

CRD IV: Capital Requirements Directive/Regulation

DG: Directorate General

DGSD: Deposit Guarantee Schemes Directive

EBA: European Banking Authority

ECB: European Central Bank

ESM: European Stability Mechanism

FCA: Financial Conduct Authority

FSA: Financial Services Authority

ICAAP: Internal Capital Adequacy Assessment Process

IGA: Intergovernmental Agreement

JST: Joint Supervisory Team

MPE: Multiple Points of Entry

NCA: National Competent Authority

NDA: National Designated Authority

PRA: Prudential Regulation Authority

RRD: Recovery and Resolution Directive

SPE: Single Point of entry

SRB: Single Resolution Board

SREP: Supervision Review and Evaluation Process

SRF: Single Resolution Fund

SRM: Single Resolution Mechanism

SSM: Single Supervisory Mechanism

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