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Meeting the challenge of the SSM
How banks should get ready for the new regime

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Summary

The Single Supervisory Mechanism (SSM) formally opens for business on 4 November. For months, supervisors and banks have been preparing for the transfer of prudential supervisory responsibilities to the European Central Bank (ECB), including through the ECB's Comprehensive Assessment exercise. Yet the 4 November milestone is just the start of a much longer, possibly testing, journey for all parties involved – significant and less significant banks, the ECB and National Competent Authorities (NCAs).

Within the ECB, the SSM is a recently formed project with a remit to introduce a new supervisory approach. It will introduce new terms of engagement: higher standards than some banks have been used to in the past; greater standardisation of approach; and a change in perspective (so that different issues might come to the fore of the supervisory relationship). These differences need to be managed and understood by banks. As the 120 banks currently identified as 'significant' for the purposes of direct supervision by the ECB go through the transition, the ones that engage in early planning and move proactively could be at a strategic advantage. In our experience, the impact of supervision on banks – both in terms of the financial cost and the call on senior management time – can be affected by how actively banks manage the regulatory relationship.

There are three important themes that banks within the SSM will need to address in order to steer their organisations successfully through the change:

1. In the words of Danièle Nouy (Chair of the SSM Supervisory Board), the SSM will be "intrusive", "tough" and "fair". It will be under close scrutiny to deliver robust and consistent supervision, and it will take care not to be seen to fail.

2. The next 12 months will be key for establishing the priorities and approach of the SSM, with the first six months dominated by addressing the findings of the Comprehensive Assessment. Banks are already asking themselves what they can learn from the Comprehensive Assessment, and the SSM principles and objectives, about the likely approach of the new supervisor.

3. Engaging with the ECB and being ready in practice for the SSM means seizing the initiative and recognising the raised expectations. For some banks, the opportunity to 'wipe the slate clean' and make a fresh start will be a benefit in itself.

Practical insights

The paper is organised in two parts:

- **Supervisory approach.** We provide an initial view on how the SSM supervisory approach will play out in practice, recognising the amount of detail yet to be clarified by the ECB. Based on the SSM's principles of supervision, we provide our view on which characteristics of the new regime will affect banks most significantly: the ambition to deliver consistent risk-based, forward-looking supervision; the likelihood that the SSM will rely heavily on quantitative techniques, at least initially; and the importance of peer group analysis.

- **Operationalising the SSM within your organisation**. Having described how the new supervisory regime may 'feel' different in practice, we share our views on how banks can operate effectively within the new supervisory set up: what the profile of the new supervisor may be and how best to address its expectations; how to manage the uncertainty which will inevitably accompany supervisory change; and what strategic implications the SSM may have.

The paper pulls together expertise from across Deloitte, gained through our work with clients on the Comprehensive Assessment exercise and preparing for the new regime. The analysis also draws on interviews carried out specifically for this paper with senior executives in several major European Union (EU) banks. In our experience, many banks are already tackling at least some of the issues we lay out. This paper provides a perspective on the key issues, and provides a means for senior managers to benchmark their own preparations against peers.

This is the latest paper in a series on the Banking Union, designed to help banks understand, plan for and manage the challenges it creates. Previous papers, which are referenced on page 17, provide an introduction to the aims and organisation of the SSM.

Supervisory approach: what will it be in practice?

New approach, new challenges

The new regime will herald changes, and those changes will create challenges for firms, not least in meeting new expectations. Policymakers have set high aspirations for the SSM: it should be credible and rigorous; it should establish a level playing field; and it should operate consistently across all banks and jurisdictions whatever their nationality. In the words of Danièle Nouy, Chair of the SSM Supervisory Board, the SSM[1] will be "intrusive", "tough" and "fair"[2].

Of course, the new regime is not being implemented in a vacuum. The SSM supervisory approach will build on existing practices and processes including the Financial Stability Board's (FSB) recommendations on the intensity and effectiveness of supervision. Several initiatives in the EU and internationally, such as the EU Single Rulebook and the revised Basel Core Principles for Effective Banking Supervision, have sought to bring greater standardisation to banking regulation and supervision over the recent past. Moreover, the ECB will apply existing EU laws and, where relevant, Member State legislation. The ECB will also apply technical standards developed by the European Banking Authority (EBA), and align with the EBA's European Supervisory Handbook.

But the approach to supervision under the SSM will change from the current national-level practices. The ECB's consistency objective may result in more constrained judgement by its supervisors and thus an emphasis on rules. A change will also be seen in supervisory priorities, and the supervisory operating model. In areas not covered by existing rules, the SSM will issue its own standards and methodologies. The ECB will also be in a position to formulate an approach to regulatory issues where EU regulation is just emerging, such as banking structural reform. Through its approach the ECB will introduce new terms of engagement: higher standards than some banks have been used to in the past; greater standardisation of approach across the Eurozone; a change in perspective (so that the issues that dominate the supervisory agenda might differ from those that previously preoccupied the local supervisors); and a new approach to the supervisory cycle.

Box 1: Challenges posed by the new supervisor

In preparing for this paper we interviewed executives from EU banks headquartered in and outside the Eurozone to understand how they were preparing for the SSM. Certain challenges were highlighted repeatedly:

1. Uncertainty around the new supervisory approach and the division of responsibilities between the ECB and NCAs;
2. Lack of clarity on how the transition process is going to work in practice when supervisory inputs are required;
3. Identifying the best way to adapt to the new supervisory culture;
4. Developing a stronger relationship with the new supervisor;
5. The need to update systems and processes to respond to the new supervisory expectations on data; and
6. The need to be able to communicate business plans, governance structures and internal control procedures so as to withstand tougher qualitative supervision.

1. We use the term "SSM" to denote the entire mechanism, including the ECB and NCAs. Within it, the ECB will be the principal driver of supervisory approach and ultimate decision maker for all banks.
2. Danièle Nouy, Interview with the Times of Malta, 5 October 2014.

Box 2: The SSM supervisory principles and supervisory cycle

The SSM supervisory approach will be based on nine principles. Even in the absence of detailed information on how day-to-day supervisory decisions will be taken, banks can deduce from these principles what the common characteristics of the new supervisory approach will be, and consider how these may translate into practice.

Figure 1: SSM supervisory principles

Principle	Description
1. Use of best practices	Supervisory model and methodologies incorporate experience of various Member States and are subject to continuous review
2. Integrity and decentralisation	Decentralised procedures and continuous exchange of information between the ECB and the NCAs should produce a unified supervisory system and continuity of supervision across SSM Member States
3. Homogeneity within the SSM	Principles and procedures are applied to credit institutions in a harmonised way to ensure consistency of supervisory actions and avoid distortions in treatment and fragmentation
4. Consistency with the Single Market	The SSM complies with the Single Rulebook and contributes to its development, as it helps to address systemic risks in Europe and strengthens convergence with respect to supervision
5. Independence and accountability	Supervision is exercised in an independent manner and subject to accountability to the European Parliament and EU Council
6. Risk-based approach	Supervision takes into account the degree of damage to financial stability from failure of an institution and probability of such failure. The SSM approach is both quantitative and qualitative, as well as forward-looking and judgement-based
7. Proportionality	Intensity of supervision varies across credit institutions, commensurate with their systemic importance and risk profile
8. Adequate levels of supervisory activity for all credit institutions	Categorisation of credit institutions according to the impact of their failure on financial stability; minimum levels of engagement are set for each category
9. Effective and timely corrective measures	Supervisory approach fosters timely supervisory action and thorough monitoring of a credit institution's response. It intervenes as early as possible (consistent with resolution procedures) to reduce potential losses for creditors

Source: ECB Guide to Banking Supervision and Deloitte analysis.

Key characteristics of the new approach

Four characteristics emerge from the new supervisory regime, and will drive the impact on day-to-day supervision. While these will be felt more acutely by the significant banks[3] the ECB will supervise directly, they will also manifest themselves in the approach to less significant banks over the longer term:

- The SSM will harmonise the conduct of risk-based, forward looking supervision in the Eurozone.[4]
- The SSM will integrate qualitative and quantitative analysis, but may have a stronger quantitative approach to supervision than most NCAs currently have, at least initially.
- Seeking supervisory consistency will be a key driver for change in how banks are supervised.
- Peer group analysis will be a key new supervisory tool, in part to deliver consistency between countries.

3. For definition of 'significant banks' see Box 5.

4. At the time of writing, no non-Eurozone EU Member State has made a formal request to opt-in to the SSM, although a number have made public statements that they wish to do so. Our analysis applies equally to such Member States if and when they join the SSM (as the SSM Regulation provides for).

1. Harmonising risk-based, forward-looking supervision

In a risk-based, judgement-led supervisory approach, which the ECB aspires to establish, supervisory resources will be targeted to those banks that pose the greatest risk to the Eurozone banking system, and to those activities that pose the greatest risk to the resilience of each bank. Closely aligned to risk-based supervision is the concept of proportionality: intensity of supervision will be scaled according to the risks that a bank poses to EU financial stability.

This approach is already hard-coded into the organisational structure of the SSM, with the size of supervisory teams and degree of oversight varying according to the significance of each bank. Information to make the judgement as to the supervisory resources and intensity of activity required for each bank will come from a variety of sources, with business model analysis, risk appetite frameworks and the results of stress tests likely to play key roles. Supervisors will be concerned with risks inherent to the business and with the evolution of risks.

Furthermore, we expect the SSM to make much wider use of, and develop a formalised approach to, thematic risk assessments exploring specific risks or specific aspects of risk management and control across a number of banks. Such thematic risk assessments will be instrumental in the proportionate application of supervision to banks of different size and complexity.

Risk-based, forward-looking supervision is already a familiar concept, as it has long been an aspect of many national supervisory practices. Through the revised EU Capital Requirements Directive (CRD IV) and the Capital Requirements Regulation (CRR), risk-based supervision has been further embedded in European supervision. But practices can vary, even where the rules do not.

What this means for banks:

- Supervisory interactions will increasingly move towards focusing on areas of concern and tackling issues raised by the supervisor quickly.
- Consequently the intensity of supervision can increase or decrease over time, once banks are part of the SSM, depending on the inherent and cyclical risks each bank is exposed to; it may also ebb and flow for different banks depending on external factors.
- The intensity of supervision under the SSM will be affected by the efficiency of banks’ risk and risk appetite management, and the effective link between risk management and strategy.
- Banks will need to strengthen internal coordination across their entities within the SSM and across – and among – all matters of concern for the SSM supervisors, including their Internal Capital Adequacy Assessment Process (ICAAP), Internal Liquidity Adequacy Assessment Process (ILAAP), Recovery and Resolution Plan (RRP) and Risk Appetite Framework (RAF). Assumptions and reporting across the regulatory programmes, plans and frameworks will need to be homogeneous.
- All reporting to the supervisor, on a regular basis or on an ad-hoc basis, will have to be well coordinated and understood by management.

Box 3: A new scope for SREP

The Supervisory Review and Evaluation Process (SREP) is the principal tool for conducting a risk and viability assessment and informing supervisory risk mitigation measures, including Pillar 2 capital add-ons under CRD IV and early intervention measures. It is the key process where supervisory judgement and challenge come into play. Through the SREP supervisory expectations on issues such as management information / data are set; and expectations such as embedding Asset Quality Reviews (AQR) and targeted stress testing in banks' business as usual activities will materialise.

The SSM approach to SREP encompasses three main elements:

1. A risk assessment system (RAS), which evaluates credit institutions' risk levels and controls;
2. A comprehensive review of the institution's ICAAP and ILAAP;
3. A capital and liquidity quantification methodology, which evaluates a credit institution's capital and liquidity needs given the results of the risk assessment.

The SSM approach is closely aligned with the consultation on SREP Guidelines which the EBA launched in July 2014. Significantly, these Guidelines extend the scope of SREP well beyond capital risk assessment to include business model analysis, assessment of internal governance and controls, and liquidity assessment. Incorporated in the SREP framework is an increased role for stress testing, both as part of the capital and liquidity assessment frameworks and as part of the supervisor's risk management evaluation. Additionally, they provide concrete guidelines on the composition of Pillar 2 capital, and outline a ranking and scoring process as a key output of the SREP.

Banks are to be assessed on a proportionate basis, being assigned to one of four categories based on their potential impact on the financial system. NCAs then have to assess and score (again on a 1 to 4 scale) each element of the SREP framework, before forming an overall assessment and an overall SREP score. These will then determine both a view of the viability of the bank and the supervisory measures that may need to be taken.

With the composition of own funds instruments and Pillar 1 calculations now 'maximum harmonised' under CRR, variations in the treatment, quantification and composition of Pillar 2 requirements will have been the principal source of variation in the prudential treatment of institutions with similar risk profiles in different Member States within the Banking Union. The variation in approach can be stark, as illustrated in the table overleaf.

Box 3: A new scope for SREP (Cont'd)

Table 1: Deviations in current NCA approaches to SREP

Area	Degree of variation	Detail
SREP process, definitions and scoring	High	• The underlying definitions and expectations can vary considerably between NCAs. For example, a 'SREP update' may constitute a full re-assessment of all elements of the SREP, or alternatively a more cursory review of known developments against existing findings. • The extent to which the SREP or a re-assessment is conducted on site versus off site also varies significantly. • Only a handful of NCAs apply business model analysis as a separate qualitative element. • Only a minority have developed liquidity risk assessment as a separate element.
Categorisation of institutions	Low	• Most NCAs have a categorisation approach, though the scope, intensity and frequency of SREP associated with each category may vary.
Approach to assessing and setting capital requirements	Medium	• Wide range of approaches, split into two broad categories – the 'Pillar 1 plus approach' with capital add-ons calculated in addition to Pillar 1 or the 'holistic ICAAP approach', where capital requirements are determined independently of Pillar 1 and translated into add-ons, if Pillar 1 is deemed insufficient. • The quality of capital used to meet Pillar 2 capital requirement can vary as can the approach to calculating it.
Approach to assessing and setting liquidity measures	High	• The application of supervisory liquidity measures, including additional quantitative liquidity requirements, is new for the majority of NCAs, which so far have mostly been addressing liquidity and funding risk shortcomings through additional own fund requirements.
Approach to recovery and resolution	Medium	• Only a few supervisors have assessed recovery and resolution frameworks prior to the Bank Recovery and Resolution Directive (BRRD).

Source: EBA and Deloitte Analysis

By introducing a consistent approach to SREP across the Eurozone, the ECB might change what 'good' looks like for capital and liquidity. The SSM approach to the SREP under Pillar 2 is expected to be much more quantitative than the approach currently adopted in the majority of Eurozone Member States. Changes to current capital add-ons and liquidity charges may also be driven by the broader set of inputs the ECB will consider when conducting SREP.

2. The ECB's approach: quantitative then qualitative

The ECB has made clear that data will be important in its approach. Statements from key SSM decision makers have indicated that the ECB's risk assessment scoring will be delivered largely through data, and will then form the basis for discussion and justification of any overrides. Moreover, in the near term, the desire to ensure homogeneity of approach is likely to be addressed by relying on quantitative approaches. That said, we expect data to play a significantly more important role in the SSM's efforts to deliver consistency in the supervision of less significant banks than in that of significant banks.

One implication of the emphasis on quantitative supervision is a hunger for data beyond standard regulatory reporting. The need for more and better quality data permeated the Comprehensive Assessment and some banks will have already received recommendations to strengthen their data governance frameworks. The need to build capabilities for risk data aggregation, closely aligned with the Basel Committee on Banking Supervision's Principles for Data Aggregation (BCBS 239), has often been emphasised. Furthermore, the ECB's leadership has stated that stress tests will become business as usual under the SSM. Asset Quality Reviews, albeit not as rigorous as those conducted in 2014, will also remain part of the supervisory toolkit.

Less has been said about the ECB's attitude towards internal models for the calculation of Risk Weighted Assets (RWA). In comparison to their peers in the UK and US, key SSM decision-makers have made fewer statements about the deficiencies of internal models, raising the question of whether the ECB will be less hawkish on this issue than some supervisors outside the Eurozone. That said, it is clear that variation in RWA calculations are firmly on the SSM's radar. Given its ability to undertake more extensive peer group analysis, it clearly has the means to tackle this.

Although the ECB has made a clear commitment to integrate quantitative and qualitative supervision, we expect the balance between the two, at least initially, to fall more on the quantitative side than some banks are currently experiencing. That said, qualitative factors (and in particular 'judgement') will be included from the outset, and their importance will increase over time. The ECB has made a clear commitment to delivering forward-looking, judgement-based supervision, but it will need to create mechanisms to do so consistently. Therefore, the ECB will have to strike a balance between, on the one hand, equipping its supervisory teams with quantitative analytical tools and clear decision-making procedures, and, on the other, giving them sufficient decision-making freedom and expertise to exercise judgement informed by first class analysis of data by DG4[5]. While supervisors will be able to overlay any quantitative scoring with judgement, they will have to provide justification for so doing. This will foster consistency around the basis on which judgements are made.

What this means for banks:

- **The supervisory emphasis on data will result in heightened expectations of data availability, quality and governance. Data needs to be complete, accurate and in the right format. Common data definitions will be introduced.**
- **Data governance, risk data aggregation and automatisation of processes such as stress testing and AQR will be a key investment. Cost of inefficiencies in processes will increase as data requests increase.**
- **There will also be increased expectations for responding quickly and accurately to supervisory requests for data.**
- **Quantitative analysis will highlight disparities between banks quickly. Banks need to ensure that disparities are not driven by poor data quality, and be prepared to explain such disparities where they are driven by bank interpretation and policy or local market idiosyncrasies.**
- **At the same time, discussions may often become less qualitative and there will be less acceptance of an individual bank's rationale for 'why we are different'.**
- **The approach to significant and less significant banks is likely to differ, with the ECB relying more on data in its supervision of less significant banks, while employing more judgement in its supervision of significant banks.**

5. For an overview of the SSM organisational structure, see Box 5.

Box 4: Key takeaways from the ECB's Comprehensive Assessment

Deloitte supported banks and supervisors across the Eurozone in the ECB's Comprehensive Assessment. The exercise provided some insights into how the ECB will operate as a supervisor and what changes banks will need to make as a result, even before the outcomes of the Comprehensive Assessment were announced on 26 October 2014:

1	Crystallising known challenges	The Comprehensive Assessment demonstrated challenges which are not novel for the Eurozone banking system – those of data availability, data consistency, compatibility in data governance systems, often a result of legacy acquisitions and systems, and inconsistencies between paper-based and digital data processing. It did, however, force these issues to crystallise in a very tight timeframe, leaving banks with (a) a benchmark of the data expectations and demands under the SSM and (b) a long list of remedial actions – based on data issues, prior to any recommendations related to capital shortfalls – which banks will be addressing in the short to medium term.
2	Changing Business as Usual (BAU)	As a legacy of the Comprehensive Assessment, many of the ECB demands will have to be integrated into banks' BAU. For example, frequent data integrity checks are likely to become the norm. AQRs will become a standard item in the supervisor's toolbox (although probably with a narrower scope or less intensive format than was the case for the Comprehensive Assessment), and may be rolled out to less significant banks.
3	Fast-forwarding data aggregation	A clear emphasis from the Comprehensive Assessment, and an expectation elsewhere, for example in the SREP Guidelines, is that banks will improve their risk data aggregation capabilities. The blueprint for this requirement is BCBS 239, currently only applicable to Global Systemically Important Banks (G-SIBs) but indicated by ECB as a core part of its future supervisory approach.
4	New stress testing approach	Stress testing was a significant feature of the Comprehensive Assessment exercise. Although the EBA exercise is by design distinct from supervisory stress testing as part of the standard cycle of activity, the emphasis placed on stress testing may be a harbinger of the direction the ECB will take (for example, within the SREP), similar to exercises in the US (CCAR) and UK. Central to this comparison is the observation that governance and processes are as important as the capital impact of the scenarios considered.
5	Showing the ECB 'in action'	The Comprehensive Assessment was also the first example of the interaction between the ECB, NCAs and Eurozone banks. We learned that the ECB is rigorous in its expectations. Space for engagement and discussion with industry was limited. Collateral data was one of the few issues where the ECB changed its stance as a result of industry feedback, but outside the set up and time pressures of the Comprehensive Assessment, this stance may change and requirements on collateral data may increase.
6	Significant implications for strategy	Differences in credit assessment methodology may have significant effects on a bank's business practices. For example, in the AQR banks were asked to make credit quality assessments on a future cashflow basis, whereas banks may be otherwise making lending decisions based on collateral. Business practices may in future have to converge on this assessment methodology, reinforced by the introduction of IFRS 9, with material implications for client relationships, product structures, staff training and data.

The supervisory emphasis on data will result in heightened expectations of data availability, quality and governance. Data needs to be complete, accurate and in the right format. Common data definitions will be introduced.

3. Supervisory consistency as a driver for change

In order to deliver a consistent, homogenous approach to supervision across all Eurozone Member States, and across significant and less significant banks, the ECB will need to embed a shared supervisory culture internally and among the NCAs.

Culture is often described as 'the way things are done around here'. Both the ECB and each of the participating NCAs have their own cultures. The culture of the SSM will be new rather than inherited, and the SSM board and senior management will need to work hard to embed it. The 'tone from the top' will be set by the Supervisory Board which has been operational for some months. The board draws together the heads of banking supervision from all the participating NCAs in a joint decision-making process which in itself will support the creation of a new supervisory culture. The Joint Supervisory Teams (JSTs) should be in the vanguard of translating this tone from the top into day-to-day supervisory practices and of identifying any divergences from it. And close coordination across DG1 and 2 and the quality control function exercised by DG4 should embed the common culture more deeply.

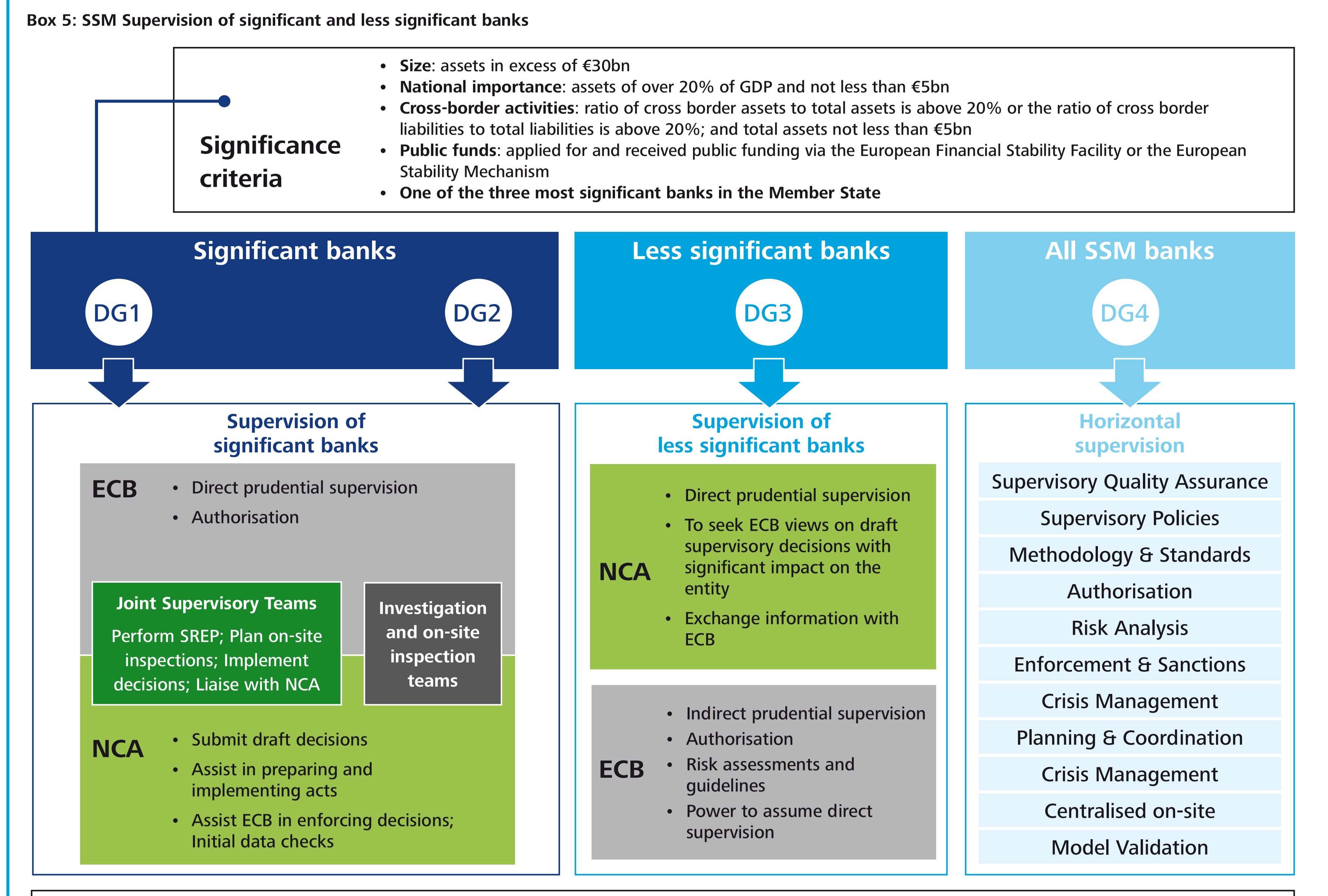
This will be an evolving process and a key initial source of uncertainty (particularly for significant banks), not least because the consistency of supervision will require successful ECB-NCA coordination. How the ECB-NCA arrangements play out in practice will depend on several factors. The SSM leadership has said that the role of NCAs will not diminish under the new regime. The SSM will rely on NCAs to continue being the first point of contact for banks in their jurisdiction, to power onsite work and, at least in the near term, to provide the know-how of the banking sector in each Member State. Moreover, the SSM Framework Regulation leaves room for NCAs' active engagement in allowing them to prepare draft supervisory decisions on their own initiative. We expect that some NCAs will be more active than others in using this power and engaging in the full cycle of supervisory work from the strategic and operational planning to the delivery of day-to-day supervisory activities.

A key aspect of delivering homogeneous supervision for the SSM will be to minimise the room left for national discretion or bias. While it is a key objective of the SSM and a principal deliverable of the EBA's SREP Guidelines, this will take time. Until DG4, the ECB's horizontal directorate, settles down and through its outputs and the concurrent work of the line-side directorates standardises the supervisory approach beyond the rules hard-coded in laws and regulations, there will continue to be some scope for NCAs to pursue local approaches.

What this means for banks:

- **The ECB will have discretion over a number of important decisions which previously sat with NCAs, for example the application of exemptions or waivers. As the ECB looks to improve supervisory consistency, banks will find some of these key decisions reversed or amended.**
- **Some past supervisory decisions may be re-visited, with a need to explain to the new supervisors why the status quo should be maintained.**
- **The challenge of implementing the new approach may mean there is an extended period of flux, during which time it is difficult to pin down the steady state supervisory position.**
- **The SSM decision-making process is multi-layered and banks may find the response time to be longer than when they dealt with their NCAs previously.**
- **The format and content of SSM policy statements remain unknown, as does the interaction between SSM line-side supervisors and the policy functions and how SSM participation in, and cooperation and coordination with, policy-making by the EBA will evolve. The balance between more detailed, hard-coded standardisation and line-side supervisory discretion has yet to be struck but the SSM concept of 'constrained judgement' suggests that the room for line-side discretion will be more limited.**

Box 5: SSM Supervision of significant and less significant banks



- All banks will comply with ECB guidelines and standards, but the ECB supervisory approach is likely to affect significant banks the most.
- The ECB will assess application for the acquisition and disposal of qualifying holdings for all SSM banks.
- NCAs retain responsibilities for macroprudential supervision, but ECB can apply higher requirements than applied by the NCA.
- Responsibility for supervision of conduct of business, financial crime and payments systems remains with NCAs.

4. Peer group analysis as a key tool

The ECB will make peer group analysis a central part of its supervisory approach. It will assess the risk profile and business model (including stability and vulnerability to a number of exogenous factors) of a credit institution in relation to its relevant peer group of banks from across the Eurozone. The question that arises is how SSM supervisors will select these groups. Characteristics of a credit institution usually refer to the institution's size, complexity, and its business model and the resulting risk profile in particular. The different business lines a bank engages in will obviously be the key determinant for its allocation to a peer group; we expect that the ECB may assign some banks to more than one peer group reflecting their major business lines and their respective size and complexity. A major feature of the SSM compared to NCAs is its ability to draw on detailed supervisory information from across the Eurozone.

Defining the right peer group and assessing a credit institution's performance against that peer group is particularly important with respect to business model analysis. The draft EBA SREP Guidelines specifically state that "for the purpose of conducting a business model analysis, the competent authority should determine the peer group on the basis of the rival product or business lines targeting the same source of profits and customers." Similarly, when assessing the competitive environment of a particular market in which the credit institution is operating, EBA SREP Guidelines suggest taking into account "the competitive landscape and how it is likely to evolve, considering the activities of the peer group" which may mean e.g. analysing expected target market growth and the activities and plans of key competitors in the target market.

The list of significant supervised credit institutions published by the ECB provides a good starting point as to how credit institutions could be grouped and what credit institutions the SSM supervisors might select for a peer group. The following table depicts key characteristics for the group of credit institutions included with balance sheet size of €500bn – €1,000bn total assets.

Table 2: Example of a peer group

Credit institution	Commerzbank	BBVA	Intesa Sanpaolo	Unicredit	ING Bank	Rabobank	Credit Mutuel
Date of figures	June 2014	June 2014	June 2014	June 2014	June 2014	June 2014	Dec 2013
Country	Germany	Spain	Italy	Italy	Netherlands	Netherlands	France
Employees	51,782	109,450	89,821	130,557	75,606	55,055	78,482
Branches	1,626	7,359	5,984	7,765	1,734	1,480	5,920
Capital position							
Total Capital	€32bn	€50bn	€47bn	€60bn	€45bn	€43bn	€33bn
Total Capital Ratio	14.9%	14.7%	17.1%	15.0%	15.2%	19.7%	15.9%
Common Equity Tier 1	€25bn	€39bn	€37bn	€42bn	€31bn	€27bn	€31bn
CET 1 Ratio	11.7%	11.6%	13.2%	10.6%	12.0%	12.6%	14.5%
Risk-weighted assets	€217bn	€337bn	€276bn	€399bn	€293bn	€216bn	€220bn
Total Assets	€583bn	€617bn	€628bn	€839bn	€819bn	€680bn	€659bn

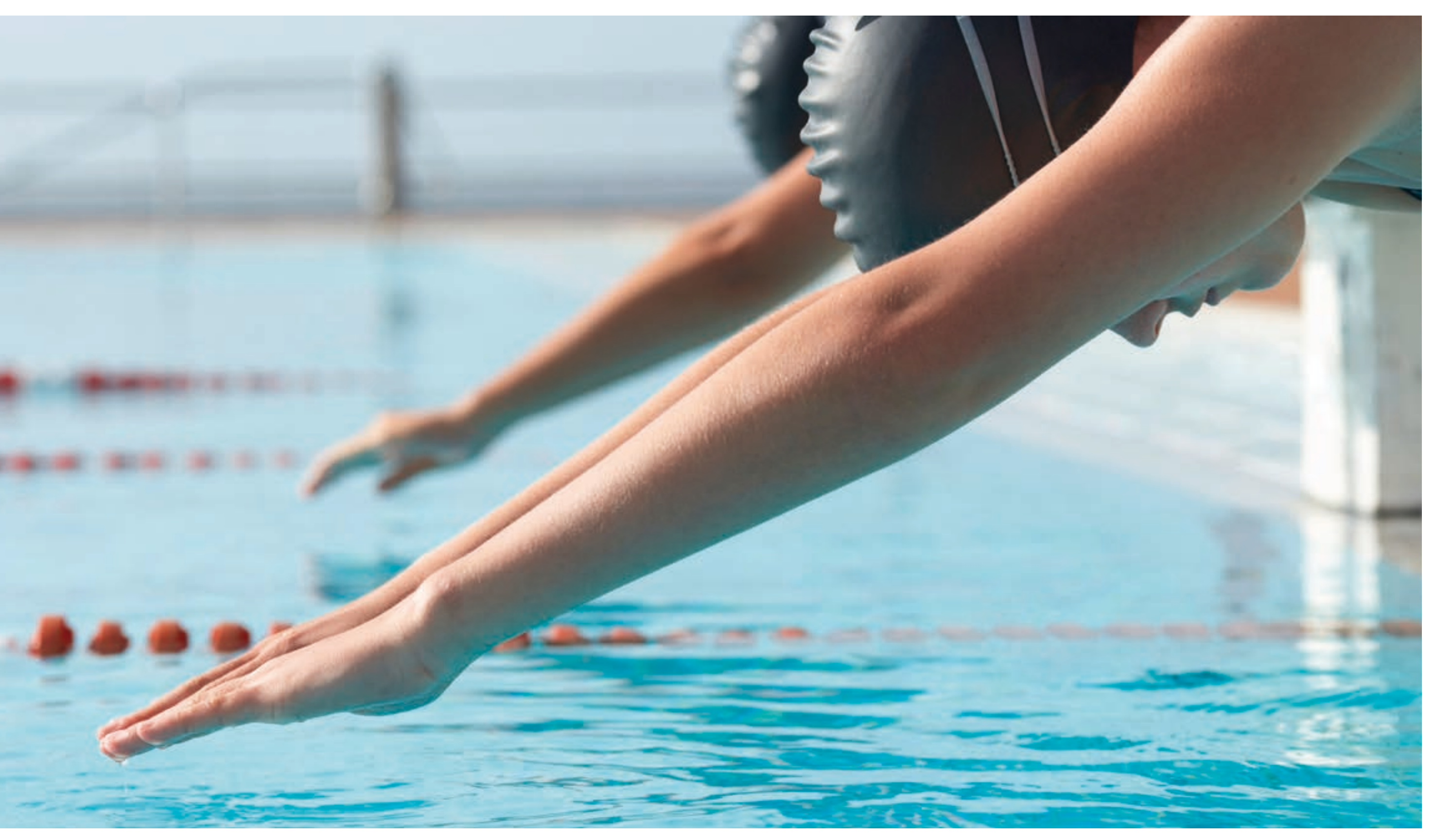
Source: Credit institutions' financial reporting

The table illustrates how difficult it is to select a consistent peer group even if firms fall into the same category in terms of balance sheet sizes. Despite similar balance sheet sizes, major differences and idiosyncrasies remain among the banks under consideration, e.g. five of them are publicly listed, the remaining two are cooperatives, and one, Commerzbank[6], is still partly state-owned. The more idiosyncratic risk profiles and business models tend to be, the more difficult it will be for the supervisors to determine the right peer group.

6. In addition to Commerzbank, ING also received financial support from the Dutch government in 2008 and 2009 to reinforce its capital position. Since then a large part of this support has been repaid and will be ultimately repaid by March 2015.

What this means for banks:

- Some of the peer groups created might be less than obvious and could end up resulting in some novel and challenging comparisons.
- Horizontal assessments and peer group analysis will have implications for supervisory standards. Supervisors are likely to attempt to ensure a level playing field by a more consistent application of rules.
- One possible outcome is to encourage a wider spread of 'best' practice across banks. This is particularly likely given how supervisory teams are set up within the SSM, with multinational teams of supervisors overseeing small groups of banks from across the Banking Union (this 'organisational peer group', i.e. the group of banks supervised by one JST, may not be identical to the peer group for analytical purposes).



Operationalising the SSM within your organisation

How should a bank operationalise the SSM within its organisation? As an item on the board agenda, the SSM has moved from being about the process of set-up – and the execution of the Comprehensive Assessment – to regulatory strategy issues. Operationalisation for the SSM means seizing the initiative; recognising the raised expectations; and taking the opportunity to make a fresh start – making engagement a competitive advantage (or at the very least not a competitive disadvantage). Managing supervisory engagement and managing inherent uncertainty (about how the supervisor will operate in practice) are particularly pertinent considerations. Banks will also need to consider if the SSM is a strategic play for them. The strategic implications of the SSM need to be set against other factors such as the macroeconomic and business environments.

Managing supervisory expectations

The change in supervisory architecture introduced by the SSM requires banks to become familiar with a new group of supervisors, who will operate according to a new set of decision-making processes and will advance a set of supervisory expectations which may differ from those that NCAs have had in the past. As banks and supervisors get to know each other, banks have an opportunity to revisit how they have handled supervisory relationships in the past and take control of how they manage the expectations of the ECB.

Coordinating the supervisory dialogue, including internally, can be a challenge. It can be a process which has evolved organically within banks, and therefore inefficiencies may be present. Addressing these inefficiencies as a matter of priority can make the switch to a new supervisor easier. Experience from changes in supervisory architecture elsewhere, for example in the UK, shows us that the banks which were able to take ownership of their supervisory relationships and deliver clear and consistent messages in response to supervisory inquiries were more successful in forming a collaborative relationship with their supervisors. Even for a data-driven institution, such as we expect the ECB to be, clarity and speed in communication will matter. This is particularly true given the learning curve that ECB supervisors will have at the start, vis-à-vis the significant banks.

The immediate task, with which significant banks have already begun, is to build a working relationship with their new line supervisors. Most clients we interviewed confirmed that they have had a chance to meet their dedicated JST in the lead up to 4 November. Still, many remained unclear on how the responsibility for day-to-day supervisory tasks, and decisions, will be split between the ECB and NCA supervisors. On paper, the JSTs, the main supervisory vehicle of the SSM, are led by the ECB but powered by the NCAs. Each JST is headed up by a supervisor from (in principle) different countries than that in which the bank is headquartered. One JST may be supervising more than one bank. In practice, the ECB personnel will comprise a small portion, around 10% for the largest banks, of the total. How cooperation between the ECB and the NCAs within the JST will evolve is a key dynamic to watch as the SSM opens its doors. During the Comprehensive Assessment, the ECB often stayed at a distance from the banks, directing conversations through the NCA, in part reflecting the imbalance in resourcing between the ECB and the NCAs. The JST coordinators are likely to break away from this dynamic. The ECB will also begin relying on independent on-site supervisory teams, which will be made up of ECB staff and led by a supervisor different from the head of the JST. However, NCAs, as the ECB has stated repeatedly, continue to play a significant role in prudential supervision. They will remain the first point of contact for banks for many purposes.

Banks will have to consider how best to engage with both the ECB and NCAs. For example, do banks need to recalibrate their supervisory communication strategy and ensure that there is clarity on which internal experts and stakeholders engage with the JSTs or the SSM leadership? Are they pro-actively thinking of which aspect(s) of their business might become a concern for the supervisors, given the SSM's objectives, stated approach and expectations? Do they have the internal flexibility to reallocate resources to addressing supervisory concerns as they arise and before they escalate? Is the bank's leadership sufficiently informed to deal with new directions of supervisory questioning?

As one would do with any important stakeholder, it is helpful to consider the so-called business personality, or profile, of the new supervisor in order to engage with it effectively. One possible taxonomy is shown in Box 6.

Box 6. Profile of the new supervisor

	Characteristic of the new supervisor	Practical implications
	1. Under close scrutiny and pressure to deliver	• The ECB will likely be a cautious supervisor, certainly initially. • Banks will need to prepare for intensive scrutiny from a supervisor with a strong emphasis on demonstrating objectivity and comparability in decision-making.
	2. With strong accountability lines to EP and the EU Council	• Banks need to understand how the new lines of accountability may influence supervisory priorities. • Banks may want to revisit their engagement strategy with the European Parliament and Council.
	3. Data and process driven	• Banks need to be prepared to evidence internal decision-making, and do so with consistency. • Banks need to be prepared to respond to ad-hoc data requests in a timely manner.
	4. Culturally and linguistically heterogeneous and geographically remote	• Clarity of communication will be increasingly important. Willingness to engage with the supervisors in a constructive manner and provide sufficient background and context to qualitative or quantitative information will be an asset. • Banks may have less opportunity to communicate with key decision makers than they are used to. • Banks may want to consider if reallocation of internal resources is justified, including whether to establish a presence in Frankfurt.
	5. Hierarchical	• It will often be the case that a bank's first point of contact at the NCA is not the ultimate decision maker, even more so than at present. • Banks will need to be aware of the SSM's internal decision-making procedures, particularly if considering challenging a supervisory decision.
	6. Resource-constrained	• The ECB will rely heavily on NCAs to power the supervisory teams. • Banks need to maintain a level of engagement with local supervisors, while increasingly engaging with the ECB itself.
	7. Approach under development	• Banks will need to be vigilant enough to capture supervisory changes and flexible enough to address them. • As the supervisory approach evolves, opportunities for constructive dialogue between the ECB and industry may emerge.
	8. Limited starting knowledge of national-level specifics	• The ECB will be relying on NCAs and banks themselves as the JSTs build the necessary knowledge of each supervised institution. • Banks may want to ensure JSTs have access to sufficient background information as they undertake their assignments.

Managing uncertainty

How the ECB's supervisory approach and priorities will differ from current national-level supervision will not become apparent immediately. Its implementation will be an iterative process and while the backbone of the approach, the SSM Supervisory Manual, has already been drafted, it is known to be an evolving document. Furthermore, much will depend on how successful the ECB is in establishing a common culture among its supervisors. That is difficult to do, as experience elsewhere has shown. Establishing a new supervisory culture from scratch is an even taller order. The challenges around recruitment do not make this easier. Additionally, banks are yet to see the SSM supervisory priorities; the findings of the Comprehensive Assessment will be a starting point for these. The ECB will also be building on the work currently undertaken by NCAs and the ECB. However, it is not clear whether the ECB will focus on generally problematic themes, problematic institutions, or a combination of the two.

This type of uncertainty is often cited by banks as a major challenge at the start of any new supervisory regime. It will not go away quickly and banks need to develop capabilities to manage its effects on their business. The surge in regulatory change since 2008 has highlighted a number of good practices banks can employ in dealing with uncertainty:

- **Understand the scope for change:** The ECB will operate within the legal framework provided by the Single Rulebook. It will implement EU Regulation directly and Directives as they have been transposed into national law. Beyond the Directives and Regulations, the ECB will have the discretion currently given to NCAs. Banks can build a database of the areas where the ECB will have discretion and thus gauge its ability to change the current supervisory approach, and, importantly, which of these changes can translate to high-impact supervisory decisions for their business.

- **Develop monitoring and analytical capabilities:** 2015 will be the year for the ECB to articulate its supervisory approach and clearly communicate it to banks, and also to formulate its priorities. Banks will need to build capacity to closely monitor both these areas of potential change. Monitoring of the Single Rulebook process, i.e. EU-level Directives and Regulations and secondary legislation and guidelines by the ESAs, will not decrease in importance either.

- **Build in flexibility:** We have seen the ECB operate with tight deadlines and to high standards of data and evidence, which continuously require banks to respond to supervisory requests with accuracy and agility. Availability of trained staff and ability to shift resources from one priority area to another will be key.

- **Actively avoid conflicts among compliance programmes:** Banks need to be able to recognise early on if supervisory engagement could lead to conflicts, in terms of resources or in terms of objectives, with existing programmes for compliance and regulatory change.

- **Strengthen record keeping:** We expect the ECB to be a data-hungry, evidence-driven supervisor, as shown by the Comprehensive Assessment and its statement of approach. Banks should ensure that they have the right processes, potentially for both data and also for record keeping, to meet these expectations. With governance arrangements facing supervisory scrutiny at both the NCA and at the ECB level, being able to evidence compliance with the spirit and objective of the rules will be key.

Is the SSM a strategic play for your bank?

In addition to tackling day-to-day interactions with the SSM, there are longer-term strategic implications for banks to consider, in particular, the inter-play between organisational and legal structure and the SSM. Banks need to consider what role the SSM plays in the strategic positioning of the firm and in decisions on optimal structure.

A bank might usually consider its organisational and legal entity structure to be fixed, but at the same time as the SSM is being established, several regulatory initiatives are prompting many banks to re-think their domestic or cross-border structure. Foremost amongst them is the BRRD and the requirement that banks' structures should make them 'resolvable'. In addition, there is the proposed regulation on banking structural reform in the EU, which is expected to introduce some form of ring-fencing. Considerations of capital and liquidity efficiency are key, influencing an assessment of the relative merits of branch versus subsidiary structures. In some countries, supervisory expectations concerning the activities carried out in branches also play a role. The combined effect may cause some banks, including banks headquartered outside the EU, to restructure their operations, including to account for the efficiency gains from having the SSM as a 'single supervisor'.

Conclusion

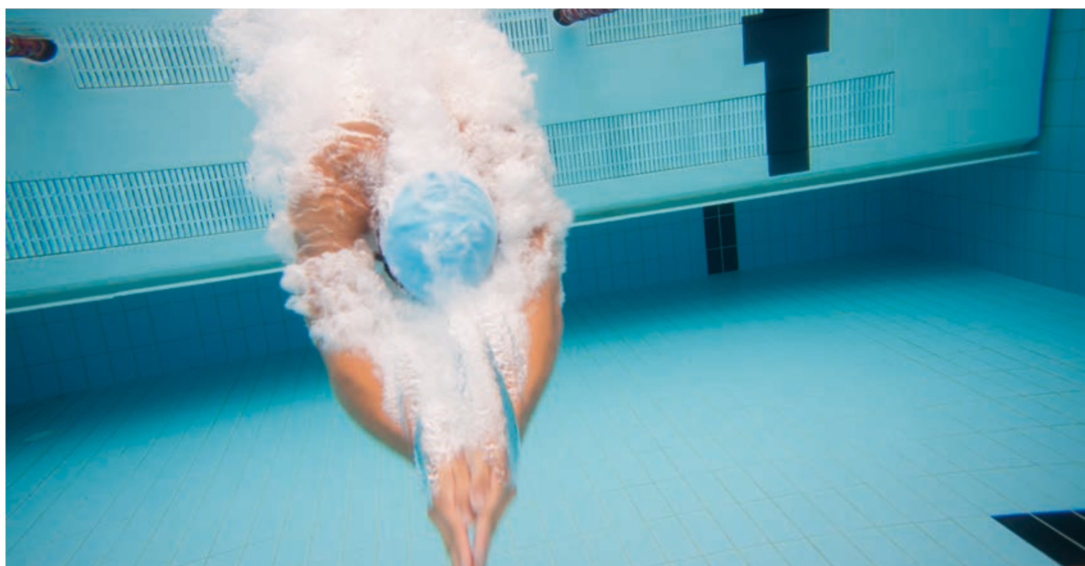
The centralisation of prudential banking supervision in the Eurozone has often been referred to as the most ambitious EU project since the introduction of the single currency. Over the coming months all parties involved in the SSM – the significant and less significant banks, the ECB and NCAs – will need to settle into their new roles. The SSM will seek to be a rigorous and intrusive supervisor, with a strong emphasis on establishing a consistent supervisory approach across the EU Member States in its scope. It will have an opportunity to introduce a change in supervisory perspective and focus, and is likely to take advantage of it.

Banks, especially those which will be directly supervised by the ECB, have repeatedly pointed to the uncertainties around the SSM approach as a key challenge. Even though much more detail will emerge as the ECB takes on its supervisory responsibilities, some characteristics of the new approach can already be identified, and traced back to its founding principles – the ECB will be an ambitious supervisor, seeking to establish a consistent standard for risk-based, forward-looking supervision; delivering comparability of supervisory decisions will be a key goal; the new approach will be deeply rooted in quantitative analysis; and peer groups will matter.

Key for operationalising the supervisory change will be the ability to form collaborative relationships with the new supervisor and to build the agility needed to adapt to its new demands.

After 4 November, the focus will increasingly move from understanding how the SSM will work in practice to analysing what the supervisory priorities of the ECB will be. The outcomes of the Comprehensive Assessment will go a long way towards highlighting the pain points for the Eurozone banking industry as a whole and will inform these priorities initially.

To be successful under the new regime, banks should be proactive – in addressing the outcomes of the Comprehensive Assessment, and beyond, in assessing which aspects of their business could cause supervisory concern, and in managing the supervisory dialogue around such issues. Any resultant changes should not be implemented in a vacuum – instead, banks should take a strategic view of how the adaptation to the new supervisory regime links to on-going and forthcoming regulatory change projects, and what synergies can be drawn. All in all, this is a new start not just for the supervisor, but for many aspects of a bank's work.



Deloitte's dedicated Banking Union resources

The Deloitte Banking Union Centre in Frankfurt

The Banking Union initiative represents a fundamental redesign of the supervision of the financial sector and will have significant consequences for European integration, as well as for the structure of the banking sector. For this reason, Deloitte established the Banking Union Centre in Frankfurt (BUCF), a powerful pan European resource to meet clients' needs and requirements. Through the lens of the Banking Union, the BUCF will be responsible for proactively identifying challenges facing banks in scope for the SSM and providing direct support to their C-suite; acting as a catalyst for pooling Deloitte's capabilities across the SSM region (the Centre will provide a single point of contact for the cross-border support that our internationally active clients increasingly require); channelling and sharing insights from Deloitte professionals on the key issues facing senior-level decision makers within banks; and supporting and extending Deloitte's existing strong relationships with the ECB/SSM and national supervisors.

Deloitte has established this permanent presence by bringing together a multidisciplinary team of senior and experienced professionals from its Financial Services practices across Europe. The Centre is led by Hans-Jürgen Walter, Financial Services Industry Leader for Germany, and includes professionals from Austria, Belgium, France, Germany, Ireland, Italy, Luxembourg, Netherlands, Spain and the UK. Additionally, the Centre is closely connected to the EMEA Centre for Regulatory Strategy (ECRS) and supported by all the Eurozone Deloitte Local Financial Services Industry practices, as well as by Helmut Bauer, Deloitte's Special Advisor on European Union Regulation, former Chief Executive Director and Head of Banking Supervision at the Federal Financial Services Supervisory Authority in Germany.

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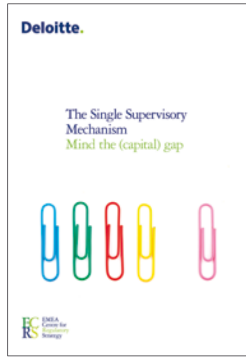

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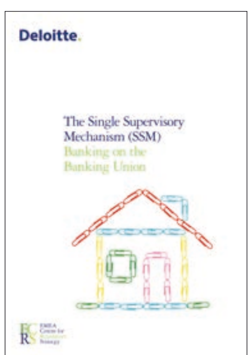

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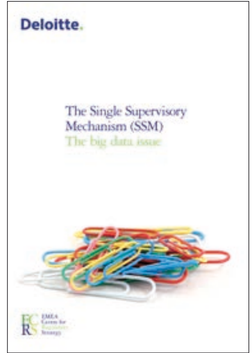

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These and other publications on the Banking Union are available on the Deloitte website:
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Designed and produced by The Creative Studio at Deloitte, London. 39296A