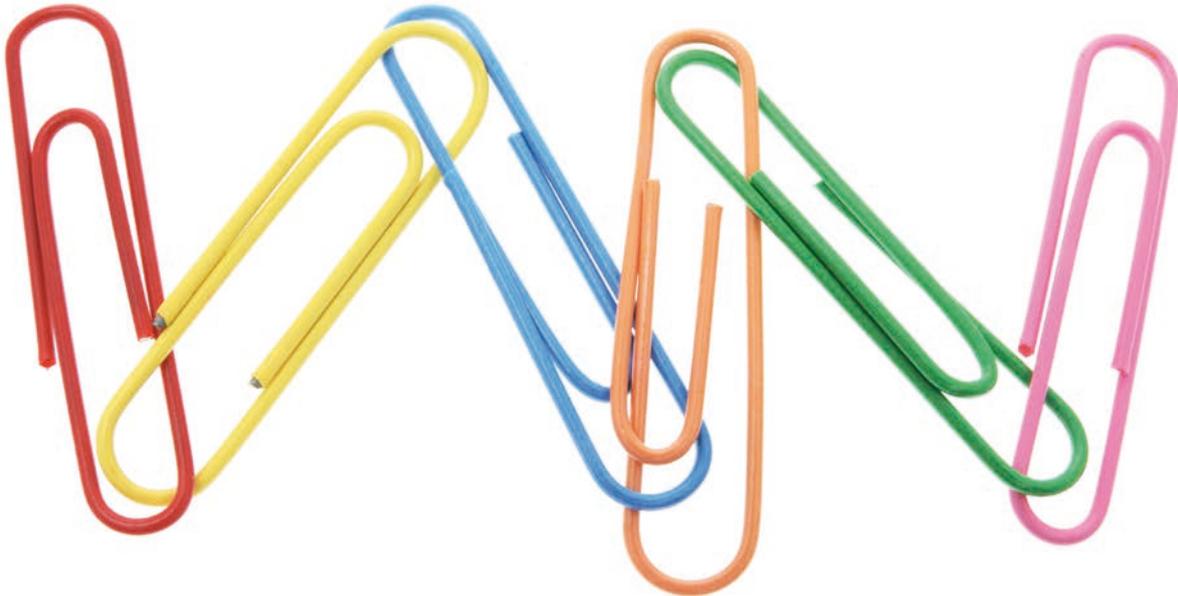


The Single Supervisory  
Mechanism (SSM)  
Stronger together?





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Just over a year after the unveiling of the proposal to set up a single banking supervisor for the Eurozone, the legislative process is coming to a close. Whilst this has been completed extremely fast by EU standards, the work that lies in front of the European Central Bank (ECB) as the new prudential supervisor of Eurozone banks will take longer, especially given the expectations placed on the new framework.

The most immediate challenge, but one with the potential to have long-term effects on the common supervisor, is its balance sheet assessment of all banks that it will directly supervise. No less important are the challenges that lie beyond that: the need for a common supervisory approach, data and analytics related issues, and managing the talent agenda. Banks will need to make sense of this brave new world, and for them the greatest challenge of all will be managing the unknown – an institution with which they are likely to have had little or no supervisory interaction to date.

This paper looks at the background and intended objectives of setting up a single supervisory mechanism for the Eurozone, and also attempts to explore some of the challenges likely to be faced by both the single supervisor and the supervised banks.

### **A new beginning**

#### **Where it all began**

In May 2012 the outlook looked bleak for the Eurozone (an economic and monetary union of 17 European Union (EU) Member States). Speculation about Greece's exit that had persisted for some time intensified following an inconclusive result in the Greek parliamentary elections. In several Eurozone countries, banks and sovereigns were caught in a downward spiral, each undermining the financial strength of the other, driving sovereign indebtedness ever higher. Financial market sentiment once again was heading towards crisis levels.

In order to restore confidence in the banks and the Euro, it was necessary to break the link – perceived and actual – between banks and their sovereigns. Policymakers concluded that a multi-pronged strategy was needed to tackle this problem, one that combined a neutral, strong and consistent supervisor for Eurozone banks, a common resolution authority (and a fund) and a fiscal backstop in case the resolution funds were exhausted.

To 'pick and mix' would not solve the problem: to put the power in the hands of a common supervisor but leave sovereigns to deal with the (fiscal) consequences would do little to break the link, whilst common safety nets without common supervision and resolution could promote the wrong incentives.

To that end, in June 2012 the European Council proposed the establishment of a Banking Union, as part of a longer term vision for further economic and monetary integration in the Eurozone. It decided that the Banking Union should have four pillars: i) a Single Supervisory Mechanism (SSM), ii) a single rulebook for financial institutions in the single market; iii) harmonised deposit guarantee schemes, and iv) a single European recovery and resolution framework. The most immediate priority was a SSM for banks, in order to make sure that all Eurozone countries could have full confidence in the quality and impartiality of banking supervision and to establish a credible starting point for the European Stability Mechanism (ESM) to recapitalise directly banks that failed to raise capital on the markets.

### Box 1. Past, present and future

On 12 September 2012 the European Commission (EC) adopted two proposals for the establishment of the SSM: the first concerning the powers and duties of the ECB that will be given bank supervisory powers under the SSM, and the second concerning the resulting changes to the already existing European Banking Authority (EBA) under the SSM. The original timetable was very ambitious, and proposed that as of 1 July 2013 all banks of major systemic importance be put under the supervision of the ECB, followed by all banks as of 1 January 2014.

Despite the initial sense of urgency, the original timeline soon slipped. Unanimous agreement on the proposals was reached in the December 2012 meeting of Finance Ministers (ECOFIN), followed by trilogue agreement in March 2013, however, the European Parliament (EP) only gave its final approval in September 2013. Publication in the Official Journal (OJ) is expected shortly. Furthermore, it is expected that following the publication in the OJ it will take at least a year for the SSM to become operational, and several years beyond that before its operating model has bedded down.

Figure 1. SSM timeline

Timeline						
Legislative process underway		Entry into force			Implementation	
Q2 2013	Q3 2013	Q4 2013	Q1 2014	Q2 2014	Q3 2014	Q4 2014
Partial EP vote	Final EP vote in Plenary (12/09)	ECB can undertake tasks other than making supervisory decisions ECB can directly supervise Credit Institutions (CIs) if required for ESM direct recapitalisation <ul style="list-style-type: none"> <li>• ECB to publish quarterly progress reports to Parliament and Council</li> <li>• ECB to publish Framework Regulation (six months after publication of SSM Regulation, to be preceded by public consultation) that will i) specify methodology for classifying CIs as 'significant' and ii) outline the precise assignment of tasks within SSM</li> </ul>			Implementation likely in Q3/Q4, unless quarterly reports suggest ECB is not substantially prepared	

The ECB has already started various work streams in order to progress some of the work. Preparatory work has been organised into five technical work streams, which cover i) initial mapping of the Eurozone banking system; ii) legal issues; iii) development of a supervisory model; iv) coordination of the comprehensive assessment of the CIs; and v) preparation of a future supervisory reporting template. The ECB's priority at the moment is work stream iv), also referred to as the balance sheet assessment (BSA), which includes an asset quality review (AQR).

### SSM 101

In a nutshell, under the SSM the ECB will be given extensive micro- and macro-prudential powers. All of the Eurozone's 6,000 Credit Institutions (CIs) will fall under the SSM's remit, although the ECB will not directly supervise all of them. CIs will be designated as 'significant' or 'less significant' (see Box 2 for criteria) and the ECB will – at least initially – directly supervise only the former category, which will comprise approximately 130 CIs. Supervision of these 'significant' CIs will be conducted by Joint Supervisory Teams, headed by ECB staff and supported by experts from the national competent authorities (NCAs). 'Less significant' banks on the other hand will remain under NCA supervision. However, the NCAs will not be fully autonomous, but will be subject to the ECB's broad oversight powers within the SSM. For example, NCAs will have to act in accordance with ECB guidelines, specific regulations and manuals of supervisory practices, as the success of the SSM will depend on supervision across the SSM being harmonised and of equally high-quality. The ECB will also have the power at any time to decide to exercise direct supervision over a CI, in particular should it have concerns over the quality of supervision. As a consequence, both 'significant' and 'less significant' CIs will see a change in the way they are supervised going forward.

Although the SSM will directly apply to Eurozone countries only, non-Eurozone EU Member States can also opt-in by establishing a 'close co-operation' with the ECB. Sweden and the UK have already stated that they will not seek to opt-in, whilst several other EU Member States have indicated that they are likely to seek to become 'participating Member States'. However, the SSM could have implications for other countries as well. One area where this could be evident is in the case of cross-border banks with operations both within the SSM and outside. The ECB will gain a seat in cross-border supervisory colleges, alongside all the other NCAs. It is likely that the NCAs that are part of the SSM and the ECB will form and defend a common point of view, which could in particular change the dynamics of supervisory college discussions of those cross-border banks that operate predominantly in SSM countries.

## Box 2. CI's designation criteria

### All CIs ('less significant' and 'significant') in the SSM: ECB prudential supervisor

- The ECB is responsible for the effective and consistent functioning of the SSM
- The ECB will be responsible for the carrying out of prudential supervisory tasks for all CIs in Member States participating in the SSM; it will hand certain tasks back to NCAs

### Less significant CIs: ECB oversight

- The ECB will only exercise oversight and issue regulations, guidelines or general instructions to NCAs

### Significant CIs: ECB direct supervision

The ECB will directly supervise 'significant' CIs, which satisfy ANY of the following requirements:

- The CI is of "significant size":**
  - Assets in excess of **EUR 30 billion**, calculated at the highest level of consolidation within participating states
  - Assets represent more than **20%** of the respective country's **GDP**
- The CI is of "significant importance to the economy of the EU of the Participating MS"**
  - NCAs** can designate a CI authorised on their territory; ECB will take the ultimate decision
  - On its own initiative, the **ECB** can designate a CI based on the size of its cross border assets/liabilities with other SSM-subidiaries
- The CI received public funding via the EFSF or ESM**
- The CI is one of the three most significant CIs in each MS**

Apart from the biggest banks in each Member State, those banks that are headquartered outside the Eurozone (both EU and non-EU) but have significant operations in Member States that will be part of the SSM will also be 'caught' by direct ECB supervision. For example, although headquartered in an EU Member State outside the Eurozone, banks such as Barclays, HSBC, Nordea and RBS have significant subsidiaries within the Eurozone, making them candidates for direct supervision. A number of non-EU banks also have significant subsidiaries in the Eurozone, including Bank of America, GE Capital and State Street.

### One amongst many

The creation of the SSM is not the only significant recent change in the EU supervisory architecture. The European System of Financial Supervision (ESFS), comprising three European Supervisory Authorities (ESAs) – the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA) – and the European Systemic Risk Board (ESRB), began operating in 2011, in response to the financial crisis. Most affected by the SSM are the EBA, due to its role in micro-prudential regulation (e.g. creation of a single rulebook for the EU banking sector), and the ESRB, due to its macro-prudential role.

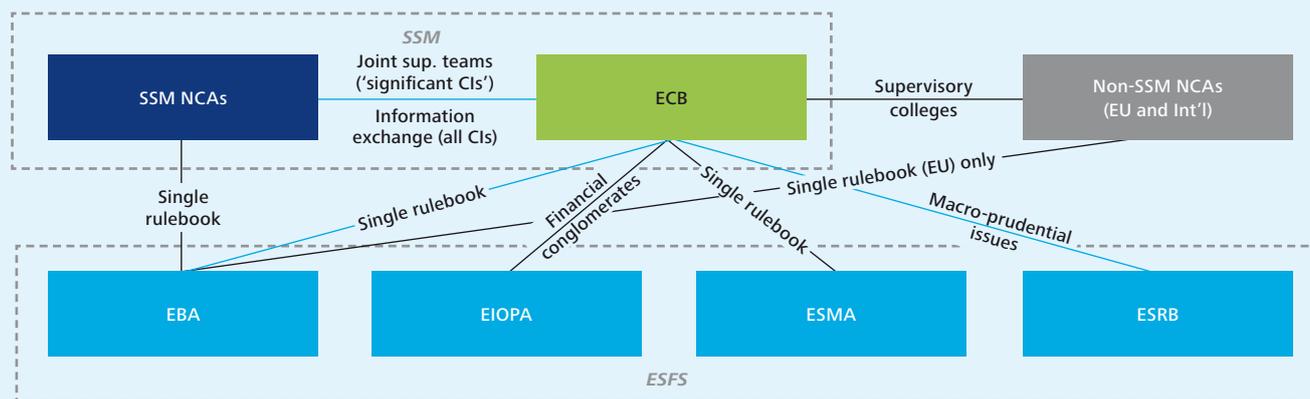
In theory, the relationship between the EBA and the ECB within the SSM was dealt with by amending the existing Regulation establishing the EBA, with voting modalities such that the SSM-countries as a whole do not 'monopolise' the rule-making at the EBA. Voting aside, the EBA will however need to make sure that all of the other work that it does is coordinated with the ECB. For example, the EBA is in the process of developing a supervisory handbook which reflects best supervisory practices across the EU. At the same time the ECB has signalled that it will develop its own more detailed supervision manual, which will outline the supervisory approach to be taken within the SSM. Similarly, the EBA has to date had responsibility for conducting EU-wide stress tests, but the ECB has indicated that it will in future undertake its own stress tests as part of the SSM regular supervisory tasks.

On both, the opportunities for divergences make cooperation between the ECB and the EBA imperative. Overall, the ECB will be a powerful new player in the EU supervisory arena, and the EBA will need to be given the necessary tools and powers to ensure it can compel any single supervisor, including the ECB if need be, to adhere to common, EU-wide practices and standards to preserve the integrity of the single market.

The roles and responsibilities of the ESRB and the ECB both overlap and are complementary. Both will be involved in the macro-prudential oversight of banks, and this is where the need for coordination will be crucial. The ESRB, which is an EU-wide body, will still be responsible for overall risk monitoring and the identification of risks to the financial sector in the EU as a whole. Since it cannot use macro-prudential tools directly, it will need to make sure that it is in a position to exercise its powers (i.e. primarily to issue Recommendations or Warnings) over the ECB as it currently does over other NCAs.



### Box 3. Relationships between ECB, NCAs and ESFS



The nature of the relationship between the ECB and SSM NCAs will depend on whether the two are dealing with 'significant' CIs, in which case they will work in Joint Supervisory Teams, or other CIs, in which case there will be less formal two-way dialogue and exchange of information. Non-SSM NCAs will have contact with the ECB primarily via cross-border supervisory colleges, and also via the EBA, given work on the single rulebook. EIOPA will need to cooperate with the ECB on matters concerning financial conglomerates. ESMA currently works jointly with the EBA on a range of topics, and may well become involved with the ECB in those areas, as well as work on sections of the single rulebook. The ESRB will need to engage with the ECB on macro-prudential issues, given the ECB's powers in this area.

### Box 4. Balance sheet assessment

Uncertainty about what is on Eurozone banks' balance sheets still looms large, despite efforts by the EBA, reassurances from national authorities and speeches from EU officials in recent years. It therefore comes as no surprise that the ECB is keen to scrutinise banks' books, to ensure it has a 'clean' start when it takes up its supervisory duties towards the end of 2014. In fact, the ECB is explicitly tasked with doing so in the SSM Regulation. According to reports to date, the ECB is planning to provide initial guidance on the exercise in mid-October, to allow banks to prepare for what is expected to be a thorough examination of their balance sheets. Early disclosure of such information could help spur some banks to take actions to strengthen their balance sheets before the official start of the exercise, to spare them the potential pain of dealing with the results at a later date. It should also help banks prepare for the detailed data requests that they will need to answer once the exercise officially starts.

The assessment itself is expected to commence in Q1 2014 but is likely to take a few months to complete. It should be completed on time to allow the EBA to carry out stress tests, all before the ECB takes over its supervisory tasks. Although the asset quality review (AQR) will be carried out by national supervisors, the ECB has been vocal about its intentions to ensure the reviews are carried out in a standardised and open fashion across all banks, to avoid some of the perceived pitfalls of earlier assessments. One way that it will seek to do this is by involving third party specialist consultancies and auditors, as well as by conducting its own internal checks of the results provided by national supervisors.

A number of national exercises have already taken place in the last couple of years, amongst them Spain (2012) and Cyprus (2013), so there could be some learning for the exercise planned by the ECB. But these national exercises took time, and involved nowhere near the number of banks that will participate in the ECB's assessment. In addition, another potential problem might be the definitions of various items that will be assessed, as well as differing national supervisory approaches. One example, raised by the Bank of Italy Governor in a recent speech, is the substantial difference in national accounting and supervisory practices, especially in the definition and measurement of non-performing loans (NPLs). It will also be important to consider what follows after the results of the balance sheet assessment are unveiled. It is almost certain that some bank restructuring and/or recapitalisation will be required, and the role, if any, that national authorities and the ECB will play in this will need to be clarified beforehand.

### Putting the SSM into practice

#### Work ahead

How to make the SSM an operational reality? While the legislation is a necessary first step – the SSM could clearly not exist without it and it provides the parameters within which the SSM will operate – it is not of itself sufficient. Ultimately it is the supervisors who govern and carry out the day-to-day supervision of credit institutions who will determine the success of the SSM. Moreover, the SSM is ambitious in scope and scale. Making the SSM an operational reality will necessitate tackling a number of challenges in the run up to the launch of the SSM and beyond.

The rewards extend beyond the primary goal of creating a Banking Union. Another key benefit is the opportunity to re-set the supervisory strategy and operational infrastructure across the Eurozone, leveraging the momentum behind the SSM project and the resources made available that in a business as usual environment would be difficult for regulatory authorities or firms to corral. All stakeholders – the ECB, the NCAs and firms – need to start now to plan and prepare to optimise their engagement and leverage the opportunities.

The ECB needs to make sure that it gets the balance sheet assessment absolutely right, as anything less could have serious reputational consequences for the SSM, and the ECB in particular, if things turn wrong later on. Yet this is no mean feat (see Box 4 for potential challenges).

Beyond that, the key near term challenges are:

- For the ECB: supervisory approach; data and analytics; talent.
- For credit institutions: managing the unknown.

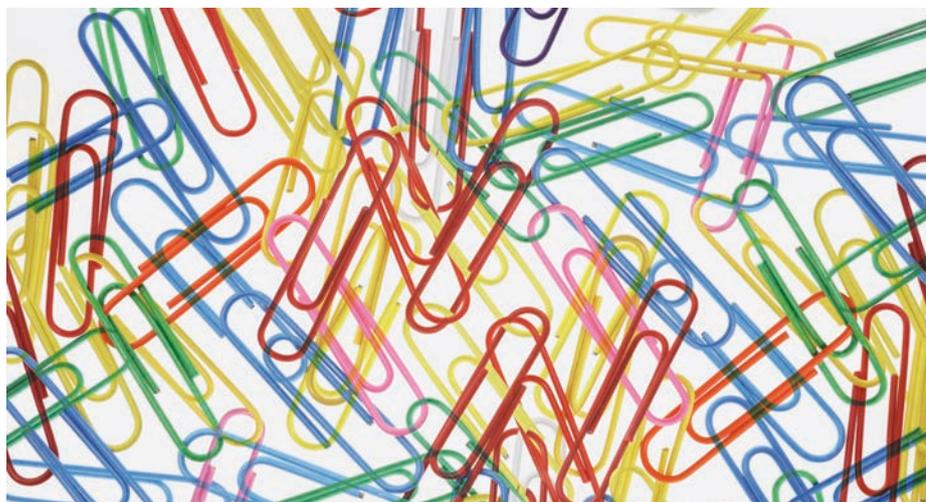
Underlying this is the question of how to resource change, and then to resource a re-set supervisory environment. Clearly there is a balance to be struck between the ECB hiring staff on a full time or contract basis and relying on support from others. The right balance is certainly not at either extreme. Key factors determining the balance are: the need to have access to experienced staff; the ability to flex quantity and qualifications of resources as supervisory priorities change; and recognising comparative advantages (and how much resource can be wasted if the right resources are not applied in the right place). Third party experts also have a role to play. Box 5 examines this in the case of auditors.

We consider each near term challenge in more detail below.

### **ECB challenge 1: Supervisory approach**

We are told that the SSM will in effect be a ‘hub and spokes’ model, with a strong centre (the ECB) working in close co-operation with NCAs to carry out supervision. There will be a single supervisory manual, a common risk assessment framework, extensive data analysis and some form of early warning indicator framework that will be designed to enable the ECB to detect emerging problems and to decide whether to move a bank from local (NCA) supervision to direct (ECB) supervision. This approach aims to strike a careful balance between the need for the ECB to exercise its responsibility for all credit institutions in the SSM and the need for the NCAs, with the expertise they have built up over many years, to remain fully and productively engaged in the practical supervisory work.

A single supervisory approach, i.e. one that is common and consistent across all members of the SSM, is key to this part of the Banking Union. It will support confidence that banks are being held to a common standard; it will increase transparency and therefore help to embed best practice across the region; and it is a necessity if there is to be an effective handoff between NCAs and the ECB as a firm’s financial condition deteriorates, or if a firm grows to become ‘significant’ (as defined by the ECB). The ECB is in a position to design and operate a supervisory approach which both learns the lessons of the current crisis and takes account of the best practices that exist at present within the various NCAs which will form part of the SSM. There should also be engagement with the banking industry and other stakeholders on this new approach, to hear their views on the strengths and weaknesses of particular models, and to draw the appropriate lessons for how the new arrangements should work.



There are many elements to a supervisory approach. In terms of design, there is the choice of supervisory strategy/philosophy, risk model and guidance on specific risks. Then there is the strategy for rolling out the new framework, including training supervisors. Finally, it is best if the approach can adapt relatively easily to future trends in banking and finance. Successful implementation relies on having the right experience mix and being able to communicate expectations clearly. Clear communication flows from a well-developed vision and approach to supervision. There is also a need to establish a dynamic approach to on-going supervision, enabling supervisors to prioritise work and to escalate the intensity of supervision as risks warrant.

Achieving the right supervisory culture needs to happen in parallel to changes in process and approach. Developing a common supervisory culture facilitates effective collaboration and reinforces common values and principles, helping to provide for similar regulatory outcomes. But more than that, supervisory culture sets the tone for supervisory judgements. One should also not underestimate several potential coordination challenges, including between the ECB and NCAs, with the EBA and with the ESRB. Ensuring a coherent approach and common standard across the Union will be difficult and will most likely take years to materialise.

### ECB challenge 2: Data and analytics

Closely related to the supervisory approach are data and analytics. Careful and intelligent analysis by the ECB of the data that banks report will be core to SSM supervision. This will form the basis of an early warning framework, with some similarity to the Prompt Corrective Action system in the US or the Proactive Intervention Framework that the PRA has introduced in the UK.

Evolving expectations about the dynamics and flexibility of supervisory activity underscore this point. A key issue in any framework is how to balance the supervisory thirst for data against the burden placed on firms and the practicalities of managing and analysing data. This is not a unique problem for the SSM, or indeed banking regulation, but the challenge is particularly pronounced for the SSM because of the breadth of institutions (number, size, type) and the fact they span multiple geographical and linguistic borders. The task is a significant, multi-year endeavour. A successful (and ambitious) implementation would make a significant difference to the effectiveness and efficiency of the SSM. It needs to draw on expertise in (predictive) analytics and stress testing and Enterprise Data Management (EDM).

#### Box 5. Role of external auditors within the SSM

It has long been recognised by the likes of the Basel Committee on Banking Supervision (BCBS) that co-operation between the supervisors and banks' external auditors enhances the effectiveness of banking supervision. The recent BCBS consultation on external audits of banks recommends that "the supervisor and the external auditor should have an effective relationship that includes appropriate communication channels for the exchange of information relevant to carrying out their respective statutory responsibilities".

To date, the relationships between supervisors and external auditors have been at the national level, enabling both parties to have access to each other's information and expertise easily. This exchange should continue with the introduction of the SSM, but due to the lack of established relationships between the ECB and many auditors, as well as physical proximity, this will require some initial effort on behalf of both. It is essential that the ECB in particular establishes relationships and engages in regular dialogue with the auditors of the CIs it will supervise directly.

Timely and open communication is important for both the auditors and the ECB, whether in case of a need for consultation or simply to ensure that each party is informed of any relevant material issues that the other may become aware of through the conduct of their own responsibilities.

Why be ambitious? New technology presents several opportunities to innovate, reducing costs and enhancing insights. In turn there are significant gains that could be achieved in the capability and capacity of supervisors to analyse firms, peer groups and the banking system. In the process, there is an opportunity to drive improvement in the way firms and NCAs generate and manage data. There are a number of relevant initiatives internationally that could be supported or implemented as part of this exercise. Operational excellence necessitates an ambitious approach to analytics and data.

### ECB challenge 3: Talent

In order to assume its supervisory duties the ECB is going to require hundreds of new staff with significant expertise for the SSM 'centre' in Frankfurt – one estimate put the number of new staff at almost 800. The first challenge for the ECB is thus finding and hiring the quantity, and more importantly the quality, of the staff that it requires. Some are likely to be seconded from the NCAs, which has both pros (e.g. experience and speed of arrival) and cons (e.g. standing/ remuneration vs. ECB recruits). The second question is how the ECB will manage the on-boarding of a large number of new staff, in particular training them in how the new common standards should be delivered.

The ECB will need to develop standards and guidelines for supervising CIs, a challenge in itself, and will need to make sure that all of its supervisors apply them in the same way so that decisions and outcomes are not divergent. A complicating factor is that this challenge applies not only to new ECB recruits in Frankfurt but equally to supervisors that will remain within the NCAs. In order for the SSM to be credible the standard of supervision must be consistent for all CIs in the SSM, regardless of whether they are supervised directly by the ECB or by NCAs. To achieve this, the ECB will not only need to look at training all of its 'direct' and 'indirect' (i.e. NCA) staff in technical aspects of supervision but also find a way to instil a common culture across the SSM. Deploying multi-country teams in the supervision of most CIs, not only those supervised directly by the ECB, may be something that the SSM should look at. If supervisors from different SSM countries come together to apply the new supervisory approach, standards and guidelines in practice, they are much more likely to develop a shared understanding. In addition, the more fungibility of supervisors that exists across the SSM, the easier it will be to move supervisors to deal with emerging problems regardless of the country in which they arise, and the less need there will be for a large 'firefighting' team at the centre.

## Challenges for CIs: Managing the unknown

It is not only the ECB that has a lot to do before SSM becomes operational, but also the CIs operating in the Eurozone (as well as in those non-Eurozone countries that join the SSM). For instance, banks need to start preparing for the balance sheet assessment, which is one of the ECB's and NCAs' priorities at the moment. CIs can for example ensure that they do as much work beforehand as possible, such as data cleansing and audit. Early preparation for what is likely to be an intense and detailed review will also give banks a head start when the AQR is followed by the stress tests in 2014.

More broadly, the relevant CIs will be affected in different ways, based on whether they are designated a 'significant' or a 'less significant' CI, which is something that the ECB should clarify in the coming months. What is certain is that all CIs, irrespective of their 'significance', will need to comply with ECB-issued guidelines, standards and, on a more practical note, things such as data collection templates and information requests. In addition, the 'significant' banks will need to get used to Joint Supervisory Teams instead of the relationship that they have with their current supervisor(s).

On a more strategic level, affected CIs will need to consider a number of important questions. Two such important issues concern CIs' compliance/risk management functions and the way their businesses operate in the EU. On the former, the CIs need to consider whether the relevant functions and infrastructure are SSM-ready: do they need more staff; how will they manage the additional and perhaps geographically remote regulatory relationship with the ECB; can they already start forming a relationship with relevant people at the ECB; are their systems ready for potential additional/entirely new data requests from the ECB? Regarding the latter, CIs need to see where their operations are located (e.g. mix of SSM and non-SSM EU countries) and how best to manage them: should or can they restructure their business to gain/avoid ECB supervision (for all/some business lines)?

Whilst planning is not easy, given the uncertainty and absence of detail, doing some of the basic 'health checks', such as the ones outlined above, will yield dividends in the long-run. Even more importantly, CIs may find that the overall standards of supervision are higher once the SSM starts operating, as it is likely that the ECB will take this opportunity to raise standards when it comes to supervisory data, risk management and other areas, to bring them in line with recent recommendations and best practice recommended by international standard setters such as the Financial Stability Board.

## Great expectations

### Major step in the right direction?

The proposal to 'centralise' prudential supervision of CIs in the Eurozone is seen by many as a step in the right direction following the turbulence caused by the financial crisis of the past few years. One of the most important benefits of the SSM is that it should alleviate concerns about differences in supervisory regimes for CIs and mark the start of tougher and more harmonised supervision. As Internal Market Commissioner Michel Barnier said after the launch of the European Commission's SSM proposal: "banking supervision needs to become more effective in all European countries to make sure that single market rules are applied in a consistent manner." For the ECB, the SSM presents a unique opportunity to raise the overall standards expected of CIs. For the CIs, it presents an opportunity to take a hard look at how they deal with supervisors – everything from the data they can provide to how they interact with the supervisory teams.

However, the SSM project will be a difficult one to deliver, both for the ECB and the firms. The ECB is faced with extremely tight deadlines – it has approximately one year to operationalise the SSM, contrasted with for example France or the UK, both of which took much longer when they recently underwent significant changes in their national supervisory architecture. In the space of one year, the ECB needs to make important decisions about the supervisory approach that it is going to take and how it is going to embed it in the NCAs; it needs to find the right people to conduct the supervisory tasks, and it needs to decide on its data and systems strategy. The tasks faced by the CIs are no less daunting, and range from operational decisions on how to prepare for the asset quality review and subsequent data/information requests from the ECB to more strategic questions about supervisory relationship management.

What needs to be done is well known, yet delivering on it successfully will require getting both the big picture and the detail just right, while still delivering on time.

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