Single Supervisory Mechanism
Trends and challenges

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In May 2012, the outlook looked bleak for the Eurozone. In several Eurozone countries, banks and sovereigns were caught in a downward spiral, each undermining the strength of the other, driving indebtedness ever higher. In order to restore confidence in banks and the Euro, policymakers concluded that a multi-pronged strategy was needed. The Banking Union was born, combining a supervisor for Eurozone banks that would be seen as neutral, strong and consistent, a common resolution authority and a fiscal backstop in case resolution funds were exhausted.

Fast-forward to November 2013 and the first pillar of the Banking Union became a reality, with EU Regulations setting up the Single Supervisory Mechanism (SSM) entering into force. The SSM, responsible for the prudential supervision of Eurozone banks, is designed to ensure that all stakeholders can have full confidence in the quality and impartiality of banking supervision, and that there is a credible starting point for the measures necessary to recapitalise banks directly.

The other pillars of the Banking Union are a single rulebook for banks in the single market, a harmonised deposit guarantee scheme, and a single European recovery and resolution framework (the Single Resolution Mechanism—SRM). Progress is being made on all fronts, however, the immediate priority for banks is the SSM.

Drawing on insights from Deloitte member firms across the Eurozone, this article sets out what is happening on the ground, where the SSM is heading, and where firms should focus their attention. The subject is primarily of interest for those banks that will be directly supervised by the ECB for prudential purposes, but all Eurozone banks will be affected by the SSM and should take note. The largest non-Eurozone EU banks should also follow developments carefully: they will be required to conduct an Asset Quality Review (AQR) exercise in 2014 under new EBA guidelines, and will take part in the EBA stress-testing exercise alongside the largest Eurozone banks.

The SSM landscape is becoming increasingly complex. Staying on the front foot by keeping track of developments and coordinating SSM-related work across the organisation will enable banks to manage the challenge strategically. It will also support them in setting the right tone for the new supervisory relationships that are being established with the ECB.

Taking stock

In a nutshell, under the SSM the European Central Bank (ECB) will be given extensive micro- and macro-prudential powers. All of the Eurozone's circa 6000 banks (formally, credit institutions) will fall under the SSM's remit, although the ECB will not directly supervise all of them. Banks have been designated as 'significant' or 'less significant', based on criteria that establish the size and importance of banks to the sectors in which they operate. The ECB will directly supervise banking groups designated as significant, which currently number 124. Supervision of these banks will be conducted by joint supervisory teams, headed by ECB staff and supported by experts from national supervisory authorities. 'Less significant' banks, on the other hand, will remain under national supervision.

The ECB is engaged in two parallel tracks of work during the transition to the SSM—which is scheduled to 'go live' in November 2014. The near-term focus for banks is the ECB's comprehensive assessment. The ECB announced in October that it will subject the 'significant' banks to a three-stage health check: an initial supervisory risk assessment, an Asset Quality Review (AQR) and a stress-testing exercise. This process has started, leading to a surge of data requests from national supervisory authorities.

The second track encompasses the work needed to make the SSM operational. A key element is recruitment, where the ECB is making steady progress. The appointment of Danièle Nouy, Secretary General of the French Prudential Supervision Authority (ACPR), as chair of the SSM in December was a key step forward. Her appointment enables the ECB to make further decisions on appointments to the SSM senior management team, which in turn will facilitate appointments to middle-management and junior positions in supervisory teams. Between 800 and 1,000 individuals will join the SSM by the end of 2014.

In turn, the SSM senior management team can begin to take policy decisions. Ms Nouy has already taken the opportunity to address some of the challenges for the SSM, such as the treatment of sovereign debt and accountability, during her confirmation hearing with the European Parliament Economic & Monetary Affairs Committee in December.

Beyond recruitment and the comprehensive assessment, less is known publicly about the remaining SSM preparatory work streams, which include finalising the design of the supervisory approach. The ECB is expected to consult in Q1 2014 on a Framework Regulation on the way it will cooperate with national supervisory authorities. It is also in the process of finalising the SSM Supervisory Manual—which by one estimate runs to 700 pages, although it is unclear whether and when this document will be made public, or how the Manual will be aligned with the Supervisory Handbook, which the European Banking Authority (EBA) is putting together on a pan-EU level.

Asset Quality Review: known unknowns

Work on the comprehensive assessment is progressing quickly. Banks were asked in October and November to provide data to assist supervisors in the initial stage, the supervisory risk assessment, which involves a quantitative and qualitative analysis of each bank's risk profile.

The first real practical challenge though for banks comes from the next stage, the AQR. The ECB asked banks to provide consolidated balance sheet data at the end of 2013—segmented by asset class and residence of borrower/counterparty—to inform portfolio selection for the exercise. The ECB's intention to be thorough is borne out by the breadth of data that has been requested. However, the data requests to support the next stages of the comprehensive assessment, the AQR proper and the stress test, will be an order of magnitude greater in terms of complexity and volume.

The assessment will cover credit and market exposures, on- and off-balance sheet positions and domestic and non-domestic exposures. The AQR will focus on the riskiest or most opaque components of each bank's balance sheet. Reviews will be conducted by national supervisory authorities, under guidance from the ECB. In most countries, national supervisory authorities plan to engage professional services firms to provide assistance.

The AQR will involve checking the valuation of assets, the integrity of reference data and related controls and processes. The specific objectives of the ECB are to provide an assessment of adequate provisioning for credit exposures, to determine the appropriate value of collateral for credit exposures and to assess the valuation of complex instruments and high-risk assets on banks' balance sheets.

Banks should invest time now and build sufficient capacity to stay ahead, not least as the tasks will become significantly more complex. Key questions remain regarding how the AQR will be organised, in addition to the uncertainty about the data required. For example, the depth of the due diligence phase covering valuations, descriptive data, and controls and processes, is yet to be fully understood.

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Looking forward

Although the AQR will occupy minds in the near-term, firms should not lose sight of the stress-testing exercise. The ECB and EBA plan to publish further details in January. And then for some firms, capital shortfall remediation, and remediation of problems identified in controls and processes, will probably come into play in the autumn.

Looking further into the future, lessons can be drawn from the comprehensive assessment, which serves as a pilot for the ECB's supervisory approach in 'business as usual'. In particular, the first stage of the comprehensive assessment, the supervisory risk assessment, will become the modus operandi for risk assessment under the SSM. The way the ECB approaches cooperation with national supervisory authorities, data requests and qualitative and quantitative assessment of risks in its risk assessment will be indicative of the style of supervision firms will experience under the SSM.

We know that as part of that assessment, the ECB will review both risk levels and risk controls across ten categories, including credit, market, operational and liquidity risk, as well as inter-risk concentration and insurance or financial conglomerate risk. The approach is intended to build on existing national practices, as well as leverage off the EBA's Guidelines for the Joint Assessment of the Elements Covered by the Supervisory Review and Evaluation Process (SREP). Data related to assessing risk levels will be gathered quarterly, whereas assessment of risk controls will be annual. The frequency of assessments themselves will depend on the nature of the risks being assessed, with liquidity risk monitored more frequently.

Judgements will have to be harmonised across the supervisory teams. There will be a learning curve for supervisors as they work towards this objective. The ECB's approach to supervision will be data-heavy, which for some banks (and supervisors) may mean more data-centric than the approach they are accustomed to. Another difference will be the ECB's emphasis on peer-group analysis in its supervisory assessment. This approach will create some novel cross-border comparators.

The new supervisory regime: final reflections

Moving responsibility for prudential supervision for the largest Eurozone banks to the ECB will improve the coherence of group supervision, as home and host supervisors for Eurozone entities of a group effectively become one. This in turn will influence the number of supervisors inputting into a group's supervisory college and, for the G-SIBs, Crisis Management Group. It should also allow the home supervisor (the ECB) to have a better overview of risk across the group, as well as how the risks and risk controls of one institution compare to its peers and to the system as a whole.

The creation and management of the new geographically-remote regulatory relationship will introduce new challenges though, with the move to a (partially) twin-peaks model of supervision, where prudential authorities and conduct of business authorities are distinct. There are potential benefits to a twin-peaks approach, but it also introduces novel challenges. For example, the balance between micro-prudential supervision, financial stability and consumer protection can become an issue. The European Supervisory Authorities have always had consumer protection on their agenda, but in the past few years this priority has been pushed back by work on the single rulebook. Possibly, the move to SSM will increase the need for more harmonised conduct of business supervision across the EU.

All in all, the supervisor is an important stakeholder for any bank. The relationship should be addressed with the appropriate level of care and concern. Banks will need to understand the ECB priorities and lines of accountability to know, on the one hand, what makes their new supervisor tick and on the other, what aspects of their bank's business could potentially be a cause of concern. The appropriate channels for internal relationship management will have to be adapted to the new landscape. Here, as elsewhere, it will be important to address such issues proactively.

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