

Consultation launched on draft ECB-SSM Supervisory Guide to on-site inspections and internal model investigations

Consultation on streamlining the Banking Union's Single Rulebook for supervisory investigations closes September 15, 2017.

As most market participants and indeed most supervisors across the EU had the summer holiday season in mind, the European Central Bank (**ECB**) acting in its role within the Single Supervisory Mechanism (**SSM**) of the Banking Union published a consultation on its draft "Guide to on-site inspections and internal model investigations" (the **OSIIM Guide**)¹. On-site inspections (**OSIs**) and internal model investigations (**IMIs**), termed in the OSIIM Guide jointly as "inspections" are key supervisory tools of the SSM.

During 2017, the SSM has increased its breadth of IMI powers and resources dedicated to its "targeted review of internal models" (**TRIM**). These SSM tools are supplemented by those powers of national competent authorities in the EU-27 and other competent powers of the European System of Financial Supervision (**ESFS**). Going forward, the level and frequency of inspections are likely to increase. At present the SSM conducts about 300 inspections a year for the ca. 125 credit institutions it directly supervises.

The OSIIM Guide consultation period commenced on July 27 and runs until midnight CET on September 15, 2017. This is quite a compact timeline given most relevant persons' calendars and the fact that this is an "open consultation", i.e., interested parties can comment on the whole breadth of the document. The OSIIM Guide is also accompanied by a FAQ² explaining the policy rationale and the context for a number of the provisions.

This Client Alert assesses the contents of the OSIIM Guide, how this development fits into wider EU and Eurozone specific workstreams and how, when compared to other SSM Guides 'qua rulebooks', this might affect Banking Union Supervised Institutions (**BUSIs**) to whom the OSIIM Guide's provisions are addressed. Further coverage on this important development will follow once the final version of the OSIIM Guide is available. At present the OSIIM Guide is available only in English, importantly, local language versions will be made available from 11 August 2017.



¹ See the following landing page: <https://www.bankingsupervision.europa.eu/legalframework/publiccons/html/osi.en.html> and the following link for the draft OSIIM Guide: https://www.bankingsupervision.europa.eu/legalframework/publiccons/pdf/osi/ssm_osi_draftguide.en.pdf?c545ba56129bf07158420cc9b436dedb

² See: https://www.bankingsupervision.europa.eu/legalframework/publiccons/pdf/osi/ssm_osi_qa.en.pdf

Unlike other SSM Guides, this Guide's overriding purpose is clear that:

"...the objective of the Guide is to provide a useful reference document for the supervised entities and other legal entities for which the ECB has decided to launch on-site inspection, as well as for the work of the on-site inspection team."

The scope of the OSIIM Guide applies to a range of entities and thus the OSIIM Guide should be seen as a dynamic tool that will evolve over time. Equally, as with other SSM rules, the contents of the OSIIM Guide may, over time, be rolled-out to a wider breadth of BUSIs or mirrored by other NCAs outside the Banking Union.

Scope of application of the OSIIM Guide

The OSIIM Guide is drafted as applying to all BUSIs, regardless of whether they are categorised as significant credit institutions (**SCIs**) for Banking Union purposes, and thus subject to direct supervision by the ECM component of the SSM, or those BUSIs that are categorised as less significant institutions (**LSIs**) and thus subject to indirect ECB-led supervision and direct NCA-led supervision.

The OSIIM Guide however aims to go beyond the jurisdictional scope of the Eurozone and its Banking Union's SSM. It also states that the OSIIM Guide applies:

"...to other legal entities which are within the scope of inspections because they have a business relationship with the supervised entity."

Collectively, the body of SCIs, LSIs and "other legal entities", which could include non-BUSI entities, are termed "**inspected legal entities**" (**ILEs**) in the OSIIM Guide. In terms of geographical and extraterritorial reach, the OSIIM Guide clearly applies to situations where the SSM's ECB component operates with the assistance of the NCAs, in non Banking Union states and in third-countries. Consequently, once the UK becomes, from an EU perspective, a third-country, the OSIIM Guide would apply in respect of ILEs located in the UK.

However, irrespective of the above, there is a bit of confusion on intended application to LSIs. As the FAQ currently states, the OSIIM Guide will only apply to LSIs where the ECB decides to make use of its powers to directly supervise the relevant LSI. Even if this is to be the case, it is quite conceivable that the OSIIM Guide will be followed by relevant NCAs in the Banking Union in relation to inspections of LSIs.

Contents of the OSIIM Guide

The OSIIM Guide is composed of three sections detailing 1: a General Framework; 2: the Inspection Process; and 3: applicable Principles for Inspections. The third section is where perhaps the majority of comments are likely to be directed during the consultation process. The legal foundations for the aforementioned sections are laid out in the founding legislation of the SSM and the CRR/CRD IV regime, along with the provisions of the SSM's internal non-public Supervisory Manual detailing processes and apportionment of responsibilities within the SSM and the interactions between centralised functions within the ECB and the individual NCAs.

Section 1 of the OSIIM Guide recaps the tasks of individual decision makers by walking through the roles of the Supervisory Board, the roles of the Joint Supervisory Teams (**JSTs**), the role of the JST Coordinator (**JSTC**), the Head of

Hot Topics

Mission (**HoM**) and the approach to finalising supervisory examination programmes (**SEP**) as well as conducting OSIs and IMIs, in a manner that conforms with the supervisory objectives.

These supervisory objectives stipulate that inspections are conducted on a risk-based, proportional, intrusive, forward-looking and action-orientated manner. To ensure these supervisory objectives are met, the HoM and the inspection team operate independently of but in coordination with the relevant JST.

One of the key takeaways for BUSIs and ILEs alike, both in terms of them wishing to comment but equally in relation to the final version of the OSIIM Guide, is that the composition of inspection teams and JSTs will matter. The composition of such teams will dictate the supervisory experience of BUSIs. Whilst the SSM, in its three years of operations, has made headway at a rapid pace, there are, as some BUSIs have commented, divergences in the experience and resourcing of certain JSTs and inspection teams. Some of these constraints are often related to language or technical experience of inspectors. This is not addressed in the OSIIM Guide and ideally merits redress to ensure resource constraints are alleviated.

Similarly, whilst JSTs and inspection teams are tasked with coordinating with Banking Union NCAs, along with other supervisory authorities within the ESFS, there is a growing consensus amongst BUSIs that greater coordination would be appreciated. This would avoid duplication and allow for a more efficient and balanced supervisory engagement process, especially across "business as usual" compliance workstreams. This is especially desirable where the NCAs in the Banking Union are separated from their conduct of business supervisory counterparts at the national level. There are a number of Banking Union supervisory priorities that require a high-degree of conduct of business input so coordination amongst supervisors is important during any SSM or national-led inspection process.

Section 2 of the OSIIM Guide sets out the individual main steps in the inspection process. These are set out in further detail in the Annex to this Client Alert. These steps include:

1. notification of an inspection to the ILE;
2. first request for information;
3. kick-off meeting;
4. on-site fieldwork phase;
5. exit meeting based on a draft report which has been shared with the relevant NCAs and ECB-SSM DG MS IV (on-site inspections) prior to being sent by the HoM with a standardised feedback template to the ILE prior to the exit meeting where the ILE has a possibility to comment on the draft report;
6. publication of final report within two weeks of the exit meeting, the HoM, taking on board any relevant written comments (if any) following the feedback (if any) at the exit meeting finalises the draft report and sends the ILE, and possibly the parent entity, if within a supervised group of BUSIs, the final report plus a letter of action/supervisory communications;
7. closing meeting; and
8. ILE's provision of its draft action plan followed by a final action plan and a follow-up from the inspection team of the ILE's final action plan.

Anyone reading the OSIIM Guide and the various steps might be forgiven to assume that the OSI and IMI provisions are always comparably slower than processes of NCAs and other national authorities in the ESFS potentially being able to act faster and earlier. That being said, the SSM does have the organisational power to accelerate the individual steps in a concurrent manner and thus react when it needs to in a more rapid fashion whilst still sequentially going through the process. And this is a risk that ILEs may want to note when amending internal policies to reflect how the OSIIM Guide may impact their business operations and when to engage support from external counsel³ in relation to scheduled inspections, thematic reviews or so-called "dawn raids".

Section 2 of the OSIIM Guide specifically sets out, what it terms "...a wide variety of inspection techniques..." these include any of the individual or a combination of the following techniques:

- **observation, information verification and analysis:** with an aim to check and evaluate the information provided by the ILE and to observe the relevant processes;
- **targeted interviews:** by meeting with relevant staff at the ILE, the inspection team collects information about inspected areas and compares the documented processes and organisational structures with the practices of the ILE, which the inspection team may challenge the interviewees. "Significant interviews" with ILEs must be conducted by at least two inspectors;
- **walk-throughs:** whereby the inspection team meet with relevant staff and ensure that the process that the ILE reports is actually embedded and applied in practice. The process aims to also evaluate consistency of provisions and locating gaps and weaknesses;
- **sampling/case by case examinations:** whereby the inspection team takes targeted or random samples of data or datasets so as to validate the results and also to gauge the level of problems in certain areas or across the business including the quality of the ILE's risk management and efficacy of other governance and control functions (the latter are implied if not explicitly mentioned). The inspection team will share the methods of data extrapolation with the ILE;
- **confirmation of data:** which involves the checking of integrity, accuracy and consistency of the ILE's data by various recalculation and benchmarking means; and
- **model testing:** which involves the ILE testing performance of its models and their output using scenario analysis with various hypothetical and historical market conditions dictated by the SSM.

Communicating the findings of an inspection and setting the remedial action plan

Following the conclusion of an inspection, the SSM will provide the ILE with a final report and also prepare the draft "recommendation". The draft recommendation is a supervisory communication that sets out the remedial actions applicable to the ILE. These supervisory communications can take two forms, namely:

³ What is interesting to note is that the OSIIM Guide makes no mention of an ILE's right, whether at the EU level and/or within individual national law and regulatory frameworks, to be represented or have counsel present in proceedings nor any reference to various rights to assert legal privilege.

1. a letter communicating supervisory expectations (**Supervisory Expectations Letter** or **SEL**) which is an SSM operational act and is thus not legally binding (but persuasive) and thus does not require a supervisory Decision, i.e., an ECB legal instrument approved by the Supervisory Board. In the event of a SEL being issued, the current draft of the OSIIIM Guide states that the ILE recipient of such a SEL does not receive a formal right to be heard to appeal against the SSM's recommendations; or
2. a formal supervisory Decision which sets out legally binding supervisory measures addressed to the ILE. The ILE has a right to be heard in respect of a Decision.

The SSM in sending its supervisory communication, in particular in the case of a Decision, may exercise other supervisory powers, notably by imposing upon the ILE:

- a. **Conditions precedent:** which suspend the legal effectiveness of the SSM's authorisation or which change or extent an internal model until the ILE has taken specific remedial action to comply with its obligations;
- b. **Limitations:** which restrict, prohibit or modify the use of a model and which may include a change to how an ILE calculates its own funds requirements, which would cause it to need to immediately raise regulatory capital;
- c. **Obligations:** which introduce remedial actions on the ILE in order to restore compliance with its obligations; and
- d. **Recommendations:** which set remedial actions upon the ILE and which whilst not legally binding, are sufficiently persuasive for an ILE to comply with the recommendation.

Section 3 of the OSIIIM Guide: Applicable principles for inspections

Section 3 of the OSIIIM Guide is arguably the most important for BUSIs during the consultation process. This section sets the tone of how the SSM inspection teams, the HoM and JSTC will discharge their supervisory mandate. It also sets the supervisory expectations applicable to the ILEs, i.e., what the SSM expects of those ILEs before, during and after an inspection.

Section 3 also details how the SSM sees its own rights vis-à-vis ILEs and equally ILEs' rights vis-à-vis the SSM. Needless to say, even after a final version is agreed upon, there are likely to be some differing views, some of which may end within the ECB-SSM's Administrative Board of Review and/or the Court of Justice of the European Union (**CJEU**).

Some of the ECB-SSM's powers and principles should be familiar to many BUSIs and ILEs and exist in greater detail in certain jurisdictions yet some are amended specifically for the SSM. Notably the OSIIIM Guide addresses the following:

- ILEs and ECB-SSM are reminded of the supervisory principle that they should work together to ensure the proper conduct and efficiency of the inspection. ILE's are reminded that their internal rules and policies should not be misused to interfere with this goal. What is not mentioned, are the legitimate expectations of ILEs, as the supervised, that the inspectors and relevant teams are sufficiently resourced and skilled.

Hot Topics

Given the range of supervisory fees that BUSIs are burdened with beyond the SSM fees, the lack of interoperation and coordination within the SSM or with other ESFS stakeholders can detract from what should ideally be approached with efficiency in mind;

- ILEs are reminded that inspection teams may, within the scope of the inspection, conduct all necessary investigations of any persons and thus request any information, explanation or justification and thus be able to obtain and check every document it requires of whatsoever nature and to take copies and extracts. What this principle however fails to mention are the applicable rules and principles of legal privilege that may operate even when dealing with a supervisory authority;
- ILEs are reminded that an inspection team has the right to interview any person, regardless of their seniority, and may request the cooperation of qualified staff of the ILE. What this principle does not adequately acknowledge are those person's rights to be accompanied or represented by inter alia legal counsel in such circumstances;
- SSM inspection teams are reminded to act in an ethical and professional manner, in accordance with applicable laws, regulations and professional procedures and to observe professional secrecy. What this principle passes by are instances where a number of qualified experts from relevant BUSIs may, in the quest of talent, join the SSM, or where certain JSTs may have an overconcentration of national bias.
- moreover, as the number of JST staff and inspections increase, the principles in the OSIIIM Guide and the SSM's internal Supervisory Manual might need a practical check of JST staff members writing up their findings on their draft reports or final reports or simply meeting notes on public transportation, whether en route to a relevant meeting or for those outside of Frankfurt, commuting back to their "home" Member States. This is particularly important as the OSIIIM Guide specifically reminds SSM inspection teams that they must comply with an ILE's internal rules on data protection, information systems and physical access to premises etc.;
- the principles in Section 3 also touch upon the rights of which language to be used during an inspection. Language matters for a number of reasons but notably that linguistic abilities can differ both within the SSM staff but equally in terms of the ILE's abilities. Any resulting disconnect can lead to a number of unintended supervisory outcomes occurring as has already been the case in respect of certain BUSIs.
- section 3 rather directly states: "Inspected legal entities are expressly asked whether they agree to use English when communicating with the inspection team and the JSTs, as a matter of efficiency." This aims to help the ECB-SSM more so than the ILE per se, however like any BUSIs who might be familiar with the practical difficulties in dealing in say Irish with the Central Bank of Ireland or Welsh with the former Financial Services Authority of the United Kingdom, English is expedient to the extent that both sides can easily communicate in it as well as have the multilingual resources, including resorting to their external counsel, to facilitate an efficient exchange of information and advice in the relevant languages and/or an English language version if needed. Communications and the inspection reports (draft and final) are drafted in English and may be accompanied by an official translation; and

Hot Topics

- moreover, language also matters given that both ILE and SSM staff may involve a number of non-native English speakers and thus even if English is the common working language used during an inspection, both sides have an interest in ensuring that each understands fully the context of concepts and expressions as they are used. Again, there are some instances of supervisory communications and conditions being "lost in translation" and these having led to adverse delays in supervisory outcomes.

As a practical tip, having multilingual external counsel being able to facilitate translation and/or sense check the differences between the English and local language version of supervisory communications from the SSM as well as the ECB-SSM's own use of certain concepts can help manage the multilingual process more cost efficiently.

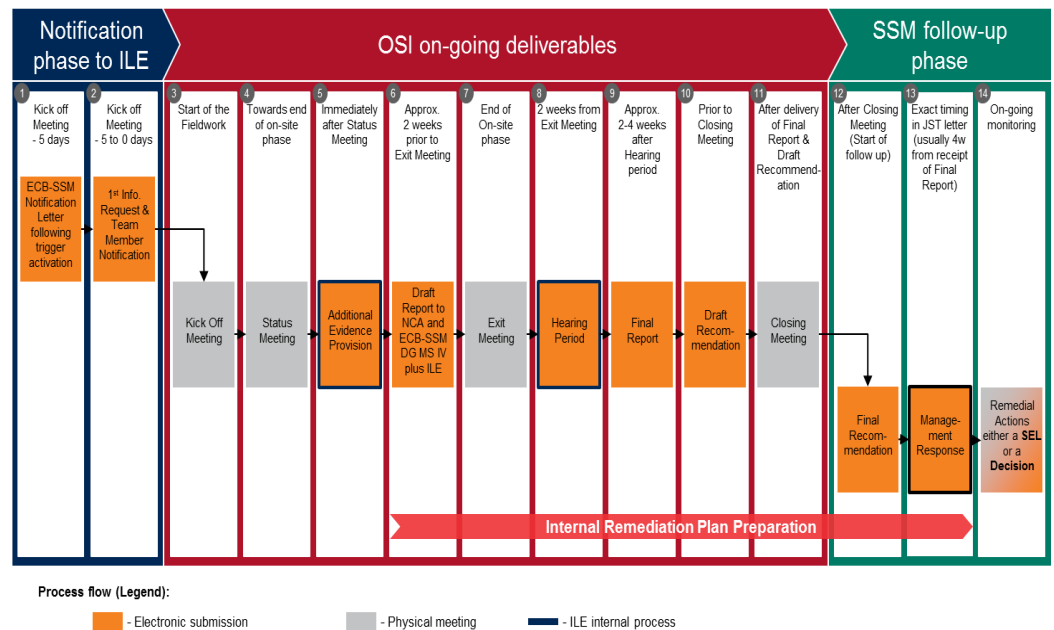
Outlook and some next steps for BUSIs

The SSM and its various supervisory guides, even if termed non-legally binding, nevertheless could not be clearer in their contents and scope of application. In each instance, and here in the OSIIM Guide, the contents have persuasive obligations and communicate supervisory expectations so that these are *qua* rulebooks that set the supervisory tone.

This means that the OSIIM Guide builds a whole Chapter in how the Single Rulebook for financial services is applied within the Banking Union. This is welcome yet also potentially beneficial for BUSIs and a range of other entities that fall within the initial category of ILEs, or financial services firms more generally as the scope of the OSIIM Guide might be mirrored by other NCAs or rolled-out by the SSM to a wider scope of persons. In any event, the advent of the OSIIM Guide lays a clearer roadmap as:

1. JST compositions begin the rotation phase with members of the JSTs changing to new teams;
2. the area of thematic reviews and TRIM led OSIs and IMIs increases as this remains a supervisory priority for 2018 and beyond; and
3. the area of thematic and ad-hoc supervisory inspections, including to non-BUSI third country entities (hence the expansion of the scope of the OSIIM Guide by reference to ILE) increases as a result of BREXIT and other relocations to the EU-27 and Eurozone-19 and its Banking Union.

Annex - the SSM's OSI Process and its impact on Inspected Legal Entities (ILEs)



How our Eurozone Hub and the wider Eurozone Group can help with inspections affecting ILEs:

Our multi-disciplinary, multi-lingual and multi-jurisdictional qualified lawyers in our dedicated Eurozone Hub and the wider Eurozone Group regularly support firms in:

1. testing readiness and resilience to inspections;
2. scenario planning how supervisory priorities, thematic reviews and SREP issues may impact inspections;
3. reviewing and improving scope of policies and processes and how these are embedded on an enterprise-wide basis;
4. assisting with legal and regulatory due diligence;
5. preparing and defending files;
6. providing project management, data protection and IT solutions including process management and supervisory engagement support;
7. assisting with implementation of supervisory remedial action plans; and
8. providing support in any appeals process.

Hot Topics

If you would like to receive more analysis from our wider Eurozone Group or in relation to the topics discussed above, including specifically what the OSIIM Guide might mean for future supervisory engagement and regulatory risk or how to submit comments during the consultation period, then please do get in touch with any of our Eurozone Hub key contacts below.

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