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ECB-SSM commits to SREP methodology to be rolled out to LSIs from 2018

How will the roll-out of the Supervisory Review and Evaluation Process to the wider banking sector affect supervision of "less significant institutions" in the Banking Union?

On 16 August 2017, the ECB-SSM published further details setting out principles on how SREP will be extended to LSIs. For some affected this will be welcome, for others it will mean additional costs and changes to engagement with supervisors both in and outside the Banking Union. This Client Alert assesses those details and how it will affect existing entities and those relocating to the Banking Union.

Context and background

Harmonising the EU's Single Rulebook, as it applies within the Banking Union, is a key supervisory priority of the European Central Bank (**ECB**), especially when acting in its role within the Single Supervisory Mechanism (**SSM**). So too is improving the consistency of supervisory practices in policing compliance by Banking Union supervised institutions (**BUSI**s). Supervisory methodology and policing of compliance will, from 2018, be rolled out to all BUSIs, regardless of whether they are directly or only indirectly subject to ECB-SSM prudential supervision[1].

One of the tools for monitoring compliance across the EU-27 but notably in the Banking Union is the Supervisory Review and Evaluation Process (**SREP**). When applied in relation to BUSIs, SREP assesses entity-specific attributes and respective compliance with obligations in the following thematic areas that are central to any SREP assessment over the monitoring period:

1. viability and sustainability of business model;
2. adequacy of governance and risk management;
3. risk to capital; and
4. risk to liquidity and funding.

The findings of the on-going SREP process are set out annually in an individual SREP Decision that is issued by the ECB-SSM. The recipient of a SREP Decision is then required to implement the quantitative (regulatory capital plus liquidity) and qualitative supervisory outcomes, recommendations and specific measures over the following year and the "SREP cycle".

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[1] The ECM-SSM's DG MS I and II are responsible for supervising SCIs. The ECB-DG MS III is responsible for supervising LSIs and notably applying closer scrutiny to High Priority LSIs. Finally, ECB DG-MS IV, amongst other shared and horizontal functions is the gatekeeper of SREP methodology and standards development.

Aside from the specific actions, a SREP Decision may specify the forthcoming frequency of periodic supervisory engagement over the SREP cycle. This may also include quarterly or more frequent supervisory monitoring and/or engagement depending on specific findings and/or the BUSIs overall SREP score calculated based on the assessment of the above-mentioned thematic areas.

More importantly in terms of costs, SREP Decisions also communicate supervisory requirements that BUSIs must fulfil in respect of the quantity and quality of their minimum amount of regulatory capital (Pillar I) as well as the additional regulatory capital or qualitative requirements (Pillar II) that the recipient is required to maintain.

Evolution of SREP

SREP's methodology, and its use as a supervisory tool, however is not new and not specific to just the Banking Union. SREP was first introduced as a tool across the EU in 2006. That introduction was led by different national supervisory and competent authorities (**NCA**s) and thus permitted certain divergences in practice.

Since then SREP has been refined in its methodology and application across the EU-27. Some of this is due to the introduction of Article 97 CRD IV along with various technical standards and supervisory guidelines published by the European Banking Authority that have established common procedures and methodologies. Those EU specific refinements were complemented by improvements in principles advanced at the national-level, notably work by the Basel Committee of Banking Supervisors (BCBS) and the work of the Financial Stability Board (FSB).

As the Banking Union took shape, the use of SREP and its methodology was harmonised further and embedded as one of the key supervisory engagement processes of the SSM. In 2015 the SSM began applying a common and harmonised SREP (**SSM-SREP**) methodology in respect of those BUSIs that for SSM purposes are categorised as "significant credit institutions" (**SCI**s). These BUSIs, approximately 130 credit institutions representing 80 % of assets in the Eurozone's banking sector, are thus subject to direct ECB-SSM lead prudential supervision. The SSM-SREP’s supervisory approach is generally characterised in its approach as being forward-looking and risk-based with a strong focus on quantitative assessments and peer group comparisons.

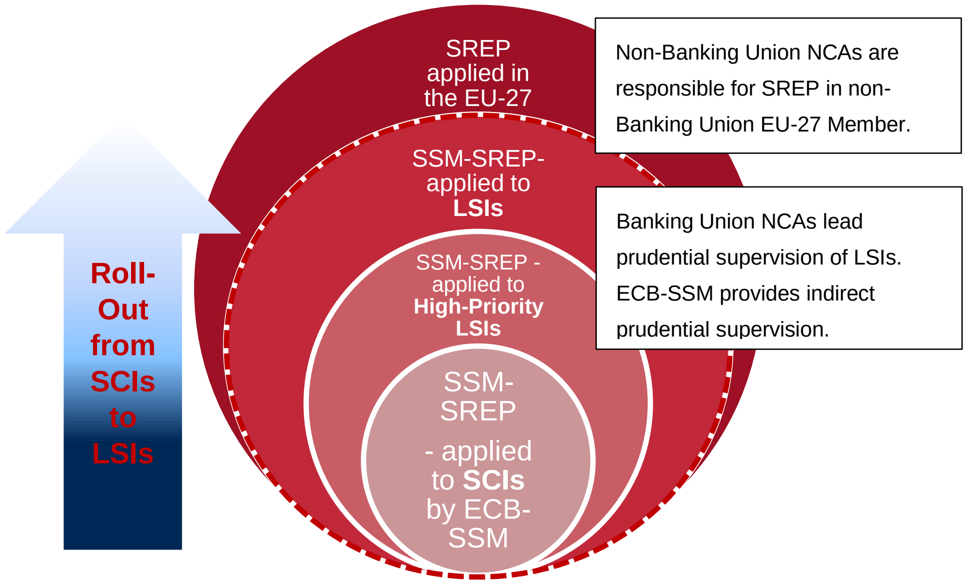
So why roll-out the SSM-SREP to LSIs now?

The ECB-SSM now wants to roll-out SSM-SREP to those BUSIs that for Banking Union purposes are categorised as less significant institutions (**LSI**s). LSIs are subject to lead prudential supervision by NCAs and indirect supervision by the ECB-SSM. This roll-out would take the SCI SSM-SREP regime and apply it to LSIs, subject to proportionate amendments. In terms of practice, this roll-out will likely incur new compliance costs and priorities for some LSIs. It is anticipated that this will first affect those LSIs that are categorised as "High-Priority LSIs" and thus subject to closer scrutiny by ECB-SSM DG MS III. The intensity of indirect supervision by the ECB-SSM is dictated by the priority of an institution. This is determined based on the LSIs risk profile and impact on the financial system.

Supervisory convergence and consistency has remained a key EU-27 and equally a Banking Union/Eurozone-19 policy objective throughout 2017. It will likely remain so through to and beyond 2019. The ECB-SSM, as one of the key drivers of promoting regulatory and supervisory consistency within the Banking Union, has increasingly followed a top-down approach in achieving convergence.

This includes harmonising provisions as they apply to SCIs under ECB-SSM direct supervision before 'rolling-out' the provisions to the much wider body of legal entities (ca. 5,000+) that for SSM purposes are categorised LSIs. The SSM-SREP roll-out to LSIs thus delivers on this goal of “levelling the playing field” in terms of the prudential supervision of BUSIs whilst concurrently ensuring a more resilient financial system by applying standards consistently across the Banking Union.

How the SSM-SREP roll-out will apply greater harmonisation to more BUSIs



Why do roll-outs matter as a regulatory and supervisory tool?

The ECB-SSM has used roll-outs to extend the scope of what is applied to SCIs to the wider-body of LSIs. This can extend to rolling-out rules, as in the case of extending the ECB-SSM's national options and discretions elimination (NODE) regime from SCIs to LSIs, and can also extend to rolling-out supervisory practices. The ECB-SSM has applied similar approaches of rolling-out rules across a number of other thematic areas that are within the SSM's regulatory and supervisory mandate. Some of these roll-outs have either been completed, or as in the case of rules on non-performing loans, are scheduled to be completed in 2018. In any event, a roll-out aims to deliver improved supervisory convergence and aims to "level the playing field" for BUSIs. In some instances it may even streamline their compliance requirements.

Separate to any roll-out process, a number of Banking Union supervisory authorities and some non-Banking Union supervisory authorities, have when discharging their supervisory obligations in relation to LSIs, begun to "mirror" ECB-SSM practice as applied in supervising SCIs. In select instances the roll-out or mirror process adds a degree of proportionality and flexibility to how rules/obligations/approaches relevant to SCIs are to be applied to LSIs. This is the case in the proposed SREP roll-out to LSIs.

The ECB-SSM's Supervision Newsletter (Summer 2017 edition), published 16 August 2017[2], contained an article "A consistent SREP methodology for LSIs"[3]. The article sets out some key principles on how the rules will be rolled-out and applied in a proportionate manner. These principles, which are likely to be extended further during 2018, build upon some previous policy announcements made across a number of ECB-SSM and other national communication channels, the article's key takeaways, which can be summarised as follows:

a. the SSM-SREP methodology for LSIs will aim to be proportionate and flexible whilst consistent within Banking Union objectives and thus help "level the playing field" for supervisors and BUSIs alike;

b. NCAs administering SSM-SREP for LSIs will have the possibility to adjust the supervisory cycle in terms of the intensity and frequency of reviews. This will be driven according to the BUSI's potential "impact on the financial system and their riskiness." This latter concept borrows from work of the European Banking Authority and the European Securities and Markets Authority to sharpen the supervisory use of risk metrics capturing probability of impact versus degree of impact;

c. this proposed tailored supervisory approach will allow adjustments to frequency but also permit different levels of granularity when assessing risk appetite and tolerance, risk level and risk controls. Equally, adjustments will be possible in terms of the review of the internal capital and liquidity positions in the form of the supervisory assessment processes: ICAAP[4] and the ILAAP[5]; and

d. NCAs will be afforded leeway in terms of how the general stress-testing framework and specific requirements are put into practice either from the bottom-up or top-down.

So what's next?

Expansion of the SSM-SREP to LSIs will likely occur in a phased approach possibly by applying to High-Priority LSIs first and then the remaining body of LSIs. The roll-out from 2018 will follow-on but also be influenced by the feedback gained from the initial testing phase that was conducted in respect of a trial-set of LSIs in individual Banking Union participating Member States. The feedback from the trial-set will likely factor in to how the SSM-SREP roll-out to LSIs is conducted.

The roll-out is set to be completed by 2020. The goal is thus that by then all LSI's are assessed using the relevant SSM-SREP model. However, this timing could pose the following issues:

- firstly, it coincides with the UK becoming a third-country post-BREXIT which is scheduled to occur at the earliest in 2019. This means that the body of LSIs and indeed SCIs that relocate to the EU-27 let alone the Banking Union may grow whilst the SSM-SREP for LSIs regime is being rolled-out;

2 See: https://www.bankingsupervision.europa.eu/press/supervisory-newsletters/html/index.en.html
3 See: https://www.bankingsupervision.europa.eu/press/publications/newsletter/2017/html/ssm.nl170816.en.html
4 internal capital adequacy assessment process.
5 internal liquidity adequacy assessment process.

- secondly, the process is set to be advanced whilst changes are being made to the CRR/CRD IV regime and whilst there is an increase in intrusive supervisory engagement at all levels of the Banking Union and the European System of Financial Supervision; and
- thirdly, the roll-out will take place during a period where the ECB-SSM leadership and indeed a number of key posts are set to be renewed or staff will be required to rotate positions and teams.

How should LSIs plan?

The impact of the SSM-SREP roll-out to LSIs will also likely have individual firm impacts. These will differ amongst firm type and relevant business models. The impact may also have differing degrees of severity. Importantly, the SSM-SREP process places a high-degree of supervisory focus and emphasis on business model analysis to determine viability and sustainability as well as risk impact likelihoods and resilience.

Whilst this roll-out and the issues flagged above certainly do not present insurmountable challenges, and whilst the SSM-SREP regime for LSIs might bring additional efficiencies in the cost of compliance, it will require careful engagement and planning from various stakeholders across existing LSIs and those relocating as a cause of BREXIT or otherwise.

Specifically, for those entities that are relocating to the Banking Union and who will become either LSIs or affiliates of LSIs, careful planning will be needed to cater for changes to comply with relevant NCA “national” SREP as a possible prelude to the SSM-SREP being rolled-out and applied by the relevant Banking Union NCA.

For those entities that will have multiple supervisory non-EU-27 supervisory touchpoints i.e., back to the UK and other global financial centres, the need to balance and possibly delineate where supervisory touchpoints end on SSM-SREP lie and where workstreams and processes can be duplicated so as to drive compliance efficiency. Some firms may want to take note of the numerous Supervisory Principles on Relocations (**SPoR**s)[6] that continue to be published by the SSM and the European Supervisory Authorities as well as NCAs that are reshaping business models and internal governance, risk and control function set-ups.

Even if the move to SSM-SREP as applied to LSIs will permit proportionality and supervisory discretion, the fact that the roll-out is being conducted to deliver on supervisory convergence means that LSIs might be faced with a supervisory engagement experience where the quantitative and qualitative analysis performed is more structured and systematic.

Some of this planning and engagement might already start prior to the roll-out taking full effect. Consequently, LSIs operating in the Banking Union and those relocating might as a result of this roll-out of SSM-SREP wish to consider:

1. setting up a working group of internal stakeholders and external advisers to conduct a preliminary review and gap analysis of how their SREP process might change due to SSM-SREP being rolled-out and what impacts this might have on any of the following:

[6] Please see our dedicated Client Alert series on this development.

a. regulatory capital planning and the link to business strategy objectives as well as how forward-looking assumptions are "anchored" on defendable forecasts, scenarios, risks and vulnerabilities, including those conceived by supervisors;

b. regulatory driven "Risk Appetite Statements";

c. ICAAP, ILAAP as well as other prudential regulatory submissions;

d. recovery and resolution planning policies and processes; and

e. design, implementation and monitoring of the adequacy and operation of governance and internal control functions;

2. use the findings of the internal review process and any external audits to identify and remedy gaps, strengthen and/or streamline processes as well as internal and regulatory driven reporting deliverables; and

3. assess how the above compares to the business environment and the relevant peer group in which the relevant LSI operates as well as the LSI's own viability.

How should LSIs monitor this development?

We will continue to monitor the developments driving and resulting out of the SSM-SREP roll-out to LSIs as it continues to evolve and shape the supervisory engagement experience of LSIs and SCIs in the Banking Union. We imagine that supervisors will continue to emphasise business model viability, profitability drivers and the on-going work on dealing with non-performing loans and exposures. We would also imagine that further scrutiny might be applied by supervisors in assessing LSI's compliance with specific rules and more generally the embedding corporate and risk culture as well as a focus on cyber-resilience.

Further insight is likely to be made available prior to 2018 when the ECB-SSM and other national and EU components of the European System of Financial Supervision publish their supervisory priorities and workplans for 2018. There are a couple of themes that LSIs will want to look out for. This includes in relation to how or whether SSM-SREP's application by supervisors to LSIs:

- will impose Pillar 2 capital surcharges on LSIs that are assessed to have inferior risk management; and
- will treat group policies and/or group support in relation to LSIs that are subsidiaries of non-Eurozone and/or non-EU-27 financial institutions.

In addition to our upcoming special feature on this development please see our Client Alert[7] on the ECB-SSM's concurrent work on its supervisory "Guide to on-site inspections and internal model investigations" (the OSIIM Guide) which might also be of interest.

[7] See our recent Client Alert on this development: http://www.bakermckenzie.com/en/insight/publications/2017/08/consultation-launched-on-draft-ecb-ssm

If you would like to receive more analysis from our Eurozone Hub or the wider Eurozone Group in relation to the topics discussed above or how we can help with specific projects and/or training needs for governance, risk and internal control functions then please do get in touch with any of our Eurozone Hub key contacts below. For a full breadth of our capabilities, resources and Thought Leadership contributions please do visit www.eurozone-hub.com.

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