

Don't be cute: ECB-SSM reminds firms that BREXIT-plans need to reflect the 2017 "supervisory principles on relocations" (SPoRs)

What do the statements on the state of SPoR compliance mean for those relocating or starting the process?

Firms relocating or looking to start the process of moving from Britain to the Eurozone have been reminded that they could and should do better. Whilst there are some that are ahead of the curve, others are lacking. Even where some are best in class in terms of their legal entity structuring post-BREXIT, they may be behind on hanging the Eurozone specific policies, processes, procedures and people on the skeleton of legal entities. Those two workstreams need to be interoperable but more importantly, especially given the concerns on SPoR compliance, be clearly delineated and have project teams and advisers that can challenge each other whilst concurrently navigating the Banking Union specifics. This is no easy feat and all of this is taking place against a sea of change that is affecting cornerstones of EU-wide as well as Eurozone specific financial regulation or how those rules are policed as part of the supervisory engagement with existing firms and those relocating.

The European Central Bank (**ECB**) in its role as the lead in the Single Supervisory Mechanism (**SSM**) pillar of the Eurozone's Banking Union uses various channels to communicate its supervisory expectations, both to financial services firms but also the national competent authorities (**NCA**). These channels are also complemented by communications from each of the European Supervisory Authorities (**ESAs**) as the technical experts and gatekeepers of the EU-27's Single Rulebook for financial services. The ECB-SSM, in addition to exercising its own rulemaking and supervisory powers, applies and tailors the Single Rulebook to the Banking Union and supervised institutions. That Single Rulebook and ultimately through how it operates in the Banking Union has created a more single supervisory culture in the Eurozone. Some of this might be culturally foreign to a number of other jurisdictions, including how the UK regulators have historically operated.

So what do Chair Nouy's statements on SPoR mean in practice and why does it matter?

The ECB-SSM is the ultimate decision-making authority in relation to authorising the application for banking licences and/or variation or extension of regulatory permissions that have been submitted to a NCA for those looking to conduct banking activity in or through the Eurozone. So when the ECB-SSM's Chair of the Supervisory Board, Danièle Nouy, reports to the European Parliament's Economic and Monetary Affairs Committee (**ECON**) her statements, such as those in her



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testimony of 9 November 2017¹, and SPoR compliance are noteworthy and of supervisory relevance.

Complying with the SPoRs is much more than legal entity structuring. In 2018 and through to post-BREXIT, the SSM's supervisory priorities and thematic areas that will be put under scrutiny will look much more closely at policies, processes, procedures and people and how they factor into a Banking Union Supervised Institution's (**BUSI**) governance, risk, legal, compliance, audit and other control functions.

Chair Nouy's statements indicate that there appears to be much room for improvement amongst the 50+ firms that have taken preliminary steps in terms of feasibility studies and/or discussions with ECB and NCA teams in the SSM or having submitted "skeleton applications" as part of the banking licence or extension of regulatory permissions process. Getting serious on compliance with SPoRs will need specialist advice on the rules, the supervisory approaches and supervisory culture as well as how it fits into the wider set of global, EU and Eurozone-specific developments that have varying degrees of impact on the "change the business", "run the business" and "change the compliance" workstreams affecting financial services firms.

Chair Nouy's statements on SPoR compliance were delivered as part of general updates and policy justifications delivered in relation to:

- *the review of the SSM Regulation*, where we expect some further administrative adjustments and streamlining of certain processes. This builds upon reforms that are being put in place following the 2016 Report of the European Court of Auditors²;
- *work on the ECB-SSM's NPL Guide Addendum*³, which is receiving political driven pushback from Italy due to what the new rules on provisioning which would put Italian credit institutions into a considerably precarious position; and
- *results of the 2017 supervisory Interest Rate Risk in the Banking Book (IRRBB) sensitivity analysis run by the ECB-SSM*, which remarked that most BUSIs were managing interest rate risk well. The update provided to ECON is timely given that the 2018 EU-wide supervisory stress tests and the start of the ECB-SSM's 2018 Supervisory Review and Engagement Process (**SREP**) review cycle are just around the corner but equally as the ECB, acting in its central bank monetary policy capacity, has begun the process to move back to normalisation i.e., reduce asset purchase volumes and flag that interest rates may return as the chief monetary policy tool going forward.

Chair Nouy confirmed that about 50 banks were speaking with the ECB-SSM or NCAs. The actual number may be higher and could grow as a number of financial institutions reassess whether some of the regulated activity that is being placed in regulated entities that may not be housed in a credit institution and thus be beyond

¹ See: <https://www.bankingsupervision.europa.eu/press/speeches/date/2017/html/ssm.sp171109.en.html>

² See: <https://www.eca.europa.eu/en/Pages/DocItem.aspx?did=39744>

³ See our coverage on this available here: http://www.bakermckenzie.com/-/media/files/insight/publications/2017/10/al_germany_ecbssmdraftnplguide_oct17.pdf?la=en

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the current Banking Union supervisory perimeter, actually ought to be conducted from a firm within the Banking Union's supervisory remit. Chair Nouy went on to state:

- *"However, the ECB is concerned that many banks are still delaying their final decision on restructuring their operations, with a view to keeping their options open."* This is a real issue given that processing times at the NCAs and equally within the ECB-SSM are going to continue to be under pressure and protracted;
- *"In assessing the relocation plans available so far, the ECB has identified some deficiencies, especially regarding the tendency to set up "empty shell" banks in the banking union, overly relying on services provided group entities in the United Kingdom".* This is a damning statement and is aimed at those that have tried to be cute rather than compliant. The two prime deficiencies are something that were central to most supervisory statements issued by the ECB prior to the ESA's and the NCAs released their own SPoRs. Whilst there may be a fair amount of finger-pointing, what is more pertinent is for a fair degree of firms to take specialist advice and remedial action;
- *"Additionally, we see a tendency to relocate bank-like activities to investment firms or third country branches which are out of the SSM's scope, thus leading to a fragmentation of supervision and possibilities for regulatory arbitrage. Here we rely on you as European legislators to introduce the necessary changes to the prevailing regulatory framework."* With the ECB-SSM and the ESA's having already been quite clear in putting supervisory convergence as the key priority of workplans in years gone by and also having been quite clear that the ECB-SSM's supervision may expand, notably in relation to the supervision of MiFID Investment Firms⁴ it would be exceptionally shortsighted to build BREXIT-plans on assumptions where the supervisors can change their scope faster than a supervised institution can rejig structures; and
- *"Significant euro area banks with a UK-footprint are also progressing in their preparations. Nevertheless, the ECB sees a need for stepping up these preparations and will continue to push banks to do so."* This statement suggests forthcoming supervisory inspections and thematic reviews⁵ on top of changes to the supervisory engagement process following the European Banking Authority's final rules on supervision of "significant branches".

Whilst the deficiencies may delay the plans and timing of a number of firms, there are a number of areas that our Eurozone Hub offer future-proofed and frontloaded solutions that can concurrently resolve deliverables across a range of existing and pending reforms and developments affecting operations of firms globally, across the EU and in the Eurozone, both when operating as a BUSI and/or under a regulated entity beyond the SSM's supervisory scope.

⁴ See our coverage in the following Client Alert: <http://www.bakermckenzie.com/en/insight/publications/2017/10/eba-mifid-investment-firms>

⁵ See our coverage in the following Client Alert: http://www.bakermckenzie.com/-/media/files/insight/publications/2017/08/al_germany_consultationlaunched_20170810.pdf

Putting this in context

The above should be read in conjunction with forthcoming coverage as well as the following publications and Background Briefings from our Eurozone Hub:

- Client Alert: *"No Easy Transition: EBA publishes its own strict supervisory principles on relocations (SPoRs)"*⁶;
- Client Alert: *"ECB-SSM releases two new supervisory "guides" on banking licence applications."*⁷;
- Client Alert: *"ECB-SSM commits to SREP methodology to be rolled out to LSIs from 2018"*⁸;
- Client Alert: *"EIOPA brings out its own 'SPoRs' plus RRP proposal"*⁹;
- Client Alert: *"ESMA publishes Sector Specific Opinions to complement supervisory principles on relocations"*¹⁰; and
- Client Alert: *"The EU and the Banking Union bring out their "SPoRs""* and Background Briefing: *"Being fit and proper in the Banking Union in 2017-ECB-SSM's supervisory guidance on fit and proper assessments"*¹¹.

Another issue that remains worth considering is that certain NCAs, in particular those that have a strong track record in their own supervisory engagement processes in the banking as well as other financial services sectors, are themselves quite active in publishing their own clarifications on how they will administer the SPoRs. This is in addition to any supervisory priorities of the NCAs that are in addition to those of EU level authorities.

The German Federal Financial Supervisory Authority (**BaFin**) published¹² an interview with Raimund Rösler, Chief Executive Director of banking supervision. What is interesting to note is that the BaFin is quite clear in reminding market participants considering Germany, especially those relocating that the BaFin is the first port of call and the file preparer for the ECB-SSM teams.

This is in contrast to statements of the ECB-SSM made at the public hearing¹³ on the supervisory guides on licence applications for credit institutions and FinTech credit institutions, details of which are available in our coverage listed above and which apply to the entirety of the licence application process for all credit

⁶ Available: <http://www.bakermckenzie.com/en/insight/publications/2017/10/eba-spors>

⁷ Available: <http://www.bakermckenzie.com/en/insight/publications/2017/09/ecb-ssm-guides-banking-licence-applications>

⁸ Available: <http://www.bakermckenzie.com/en/insight/publications/2017/08/ecb-ssm-commits>

⁹ Available: <http://www.bakermckenzie.com/en/insight/publications/2017/08/eiopa-brings-out-spors>

¹⁰ Available: <http://www.bakermckenzie.com/en/insight/publications/2017/08/esma-publishes-ss>

¹¹ Both available via: <http://www.bakermckenzie.com/en/insight/publications/2017/08/eu-banking-union-spors>

¹²

https://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Fachartikel/2017/fa_bj_1710_Brexit_en.html

¹³ The webcast of the public hearing of 26 October 2017 is available here:

https://www.bankingsupervision.europa.eu/legalframework/publiccons/html/licensing_and_fintech.en.html#

institutions applying within the Banking Union. The BaFin also states that establishing third-country branches might remain an alternative to using subsidiaries. However, the use of third-country branches as a post-BREXIT legal entity structuring solution may not have the same level of endorsement from other Banking Union NCAs. It may also fall foul of the spirit of the SPoRs, which for a number of reasons encourages using subsidiaries and holding companies including for resolution purposes

Consequently, certain NCAs may continue to advance complementary or supplementary supervisory points of engagement when exercising their Banking Union and/or non-Banking Union supervisory tasks across. In any event, whilst Banking Union has made the Single Rulebook more single, the narrative from respective NCAs add local market context and own standards, notably in those areas where the NCA is the lead competent authority rather than the ECB-SSM.

This is especially the case in relation to supervisors reiterating the fact that those relocating will need to embed EU-level but equally local conduct of business standards in their policies, processes, procedures and also in respect of persons. It will simply be deemed insufficient if a relocating firm fails to adapt its existing arrangements to the conduct of business arrangements in the respective jurisdictions it plans to operate in and from post-BREXIT or engage in outsourcing in a manner that breaches existing rules and concepts refined in the SPoRs. One area where consensus could not be clearer is that that firms need to comply with the SPoRs and start the relocation process sooner rather than later.

Outlook and next steps

As a result, in light of Nouy's statements and verdict on SPoR compliance levels affected firms will need to:

- review existing and pending BREXIT-proofing and relocation plans, some of which might need to be revisited to make sure assumptions made on the structuring side of things do not fall foul of the SPoRs and other supervisory expectations and take remedial action if necessary;
- certain decisions will, notably in relation to outsourcing or booking models, even if structured in a SPoR compliant manner, require greater degree of documented justification as to why a particular decision was taken and the circumstances influencing that decision and the evaluation of adequacy of control functions; and
- allocate sufficient time and resources in order to take account of potentially more protracted and more invasive supervisory touchpoints along each of the levels of supervisory engagement. In addition to reviewing structuring assumptions, in-house steering teams may want to consider appropriate support in relation to preparing SPoR friendly policies, procedures, processes and people in relevant strategic and risk taking roles as well as the requisite control functions.

Please do get in touch with any of our Eurozone Hub key contacts below if you require specialist support with your licence applications or variation of permissions or if you would like to receive more analysis from our wider Eurozone Group or in relation to the topics discussed above, including the ECB-SSM's supervisory priorities what this might mean for specific market participant types.

Eurozone Hub Contacts



Michael Huertas, LL.M., MBA
Counsel
Solicitor (England & Wales and Ireland)
Registered European Lawyer - Frankfurt
michael.huertas@bakermckenzie.com



Sandra Wittinghofer
Partner
Rechtsanwältin and Solicitor (England & Wales)
sandra.wittinghofer@bakermckenzie.com



Dr. Manuel Lorenz, LL.M.
Partner
Rechtsanwalt and Solicitor (England & Wales)
manuel.lorenz@bakermckenzie.com

Baker & McKenzie - Partnerschaft von Rechtsanwälten, Wirtschaftsprüfern und Steuerberatern mbB

Berlin

Friedrichstrasse 88/Unter den Linden
10117 Berlin
Tel.: +49 30 2 20 02 81 0
Fax: +49 30 2 20 02 81 199

Dusseldorf

Neuer Zollhof 2
40221 Dusseldorf
Tel.: +49 211 3 11 16 0
Fax: +49 211 3 11 16 199

Frankfurt am Main

Bethmannstrasse 50-54
60311 Frankfurt / Main
Tel.: +49 69 2 99 08 0
Fax: +49 69 2 99 08 108

Munich

Theatinerstrasse 23
80333 Munich
Tel.: +49 89 5 52 38 0
Fax: +49 89 5 52 38 199

www.bakermckenzie.com

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