

ECB-SSM sets 2018 supervisory priorities and new SREP methodology

How will this impact Banking Union Supervised Institutions (BUSIs)?

As 2017 draws to a close, the European Central Bank (ECB), acting in its lead supervisory role within the Banking Union's Single Supervisory Mechanism (SSM) published its '**2018 Supervisory Priorities**'¹ setting out what thematic areas it will concentrate on in the coming supervisory cycle as well as its '**2017 Methodology Booklet**' on how the ECB-SSM will apply the supervisory review and evaluation process (SREP) in 2018². A presentation providing further background including in relation to the 2018 SSM run Stress Test as well as the separate 2018 "Risk Map" published³ first November 2017 was also made available on 18 December 2017 (the **Background Presentation**)⁴.

These 'New Year's' resolutions are key to assessing who will make the supervisory "naughty or nice" list in a full year of regulatory change during 2018 and beyond. They are also relevant with a longer term view to 2019 and the range of BREXIT-driven changes as well as firms having to comply with prescriptive "supervisory principles on relocations" (SPoRs) issued during 2017 by the European Supervisory Authorities and the ECB-SSM⁵.

This Client Alert assesses the 2018 Supervisory Priorities and the 2017 Methodology Booklet. The developments discussed herein are assessed in further detail in a standalone Background Briefing from our Eurozone Hub entitled "**Navigating beyond the horizon: the Eurozone's regulatory and supervisory priorities shaping 2018**".

SSM key supervisory takeaways for 2018

The SSM's supervisory priorities continue to concentrate on a number of multi-annual initiatives and also introduce follow-ups to workstreams started in previous years. A strong supervisory focus on resolving non-performing loans and

¹ See https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.supervisory_priorities_2018.en.pdf?3b4a89e9ad114ff7dbdaf156d0f0f564

² See: https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.srep_methodology_booklet_2017.en.pdf
³ https://www.bankingsupervision.europa.eu/press/publications/newsletter/2017/html/ssm.nl171115_3.en.html

⁴ See: https://www.bankingsupervision.europa.eu/banking/srep/2017/shared/pdf/ssm.presentation_20171218.en.pdf

⁵ See *inter alia* the following: http://www.bakermckenzie.com/-/media/files/insight/publications/2017/11/al_germany_ecbssm_nov17.pdf?la=en plus our on-going coverage as the SPoRs continue to reshape supervision.



exposures⁶ (hereinafter **NPLs**) as well as supervisory dialogue to improve capital and liquidity adequacy assessments remain very much an on-going supervisory priority. With the ECB-SSM being able to rely on new supervisory tools in 2018 this may merit BUSIs taking more tangible action.

As in preceding years, the ECB-SSM's supervisory priorities set resolutions for the coming year. Whilst some of the headings may differ, content-wise these build upon the experiences gained throughout the past supervisory cycle. The ECB-SSM collates this input and assesses the risks and challenges faced by BUSIs, taking into account input from the Joint Supervisory Teams, ECB microprudential and macroprudential analyses plus reports from EU and international bodies. The ECB-SSM also periodically compares its own approach to those of its peers both in terms of how the principles of the Single Rulebook for financial services are applied in the context of Banking Union, as well as how it is doing in strengthening the development of a common supervisory culture within the ECB but also amongst the national components of the SSM as well as the SSM's interoperability with corresponding authorities across the Banking Union and the EU's wider European System of Financial Supervision.

The following table shows the direction of travel in terms of the 2018 Supervisory Priorities. Whilst much may seem familiar, and a number of items have remained the same as a "constant priority since 2016", it is important to note that the ECB-SSM now has, and will in 2018, have much more supervisory powers, tools and finalised expectations and guidance in place. Given the amounts of guidance and rulemaking it has communicated as applicable to the body of BUSIs, the ECB-SSM has a far greater set of specific supervisory expectations and principles that it may measure compliance against. On top of this comes the fact that even if the amount of BUSIs has been adjusted downwards to 119 during the course of 2017, the expectation is that, regardless of BREXIT, various new licensed BUSIs that are directly supervised by the ECB-SSM will rise above that number.

Thematic Area	Supervisory priority and key action in		
	2016 ⁱ	2017 ⁱⁱ	2018 & beyond to 2020
<i>Business model and profitability risk</i>	<ul style="list-style-type: none"> Thematic review and horizontal analysis of profitability drivers 		<ul style="list-style-type: none"> Follow-up on sensitivity analysis of the 2017 interest rate risk in the banking book (IRRBB) exerciseⁱⁱⁱ
<i>Credit Risk</i>	<ul style="list-style-type: none"> Task Force on NPLs Thematic Review IFRS 9 and adequacy of implementation readiness plus provisioning 	<ul style="list-style-type: none"> issuance of ECB-SSM NPL Guide^{iv} supervisory dialogue on NPLs Thematic review on IFRS 9 and adequacy of implementation readiness plus provisioning Improvements to On-Site Inspections^v 	<ul style="list-style-type: none"> assessing compliance with ECB-SSM NPL Guide, NPL strategies and timeliness of provisioning and write-offs Investigation of exposure concentrations and, notably in the context of work conducted on shipping loans to be rolled out to real-estate Supervisory attention on collateral management and valuation practices
<i>Capital adequacy</i>	<ul style="list-style-type: none"> Review of quality and consistency of Internal Capital Adequacy Assessment Processes (ICAAP) multi-annual "Targeted Review of Banks Internal Models" (TRIM) 		

⁶ For full access to our on-going coverage on NPLs and the EU as well as Banking Union regulatory response please refer to [Baker McKenzie's Insight Page](#).

Hot Topics

	<u>2018 publication and supervisory output following</u> <ul style="list-style-type: none"> o ECB-SSM final Guide to on-site inspections^{vi} o ECB-SSM final Guide on model approvals^{vii} o ECB-SSM final Guide on ICAAP and ILAAP^{viii} 		
<i>Risk governance and data quality</i>	<ul style="list-style-type: none"> • Dear CEO letter clarifying supervisory expectations to boards • Thematic review of BCBS 239 compliance with risk data aggregation, risk reporting and IT risks 	<ul style="list-style-type: none"> • Thematic review on outsourcing, related risks and IT risks • Thematic review of BCBS 239 compliance with risk data aggregation, risk reporting and IT risks 	<ul style="list-style-type: none"> • Follow-up monitoring on IFRS 9 implementation • Preparedness monitoring for compliance with the net stable funding ratio (NSFR) and minimum requirements for own funds and eligible liabilities (MREL) requirements
<i>Liquidity</i>	Dialogue on adequacy of Internal Liquidity Assessment Processes (ILAAP)	Verification of implementation of ILAAP	<ul style="list-style-type: none"> • Publication of ECB-SSM Final Guide on ILAAP • Supervisory attention on improving transparency around risk-by-risk composition of Pillar II prudential requirements
<i>Identified multi-risk issues and drivers</i> <i>(new risks are in <u>bold underline</u>)</i>	<ul style="list-style-type: none"> • reversal of the search for yield • credit risk and heightened levels of NPLs • conduct and governance risk • sovereign risk • geopolitical risk and growing vulnerabilities in emerging economies • IT and cybercrime risk • BUSIs' ability to meet upcoming regulatory capital requirements 	<ul style="list-style-type: none"> • the ultra-low/negative interest rate environment • high levels of NPLs and lacklustre economic growth across Eurozone countries • EU geopolitical uncertainties • the reactions of BUSIs and markets to new regulation • a potential reversal of risk premia in financial markets • the situation in emerging market economies • EU fiscal imbalances • cases of misconduct by BUSIs • <u>developments in real estate lending markets</u> • cybercrime and IT disruptions • <u>non-bank competition (incl. FinTech)</u> 	<ul style="list-style-type: none"> • the protracted low interest rate environment • large stocks of NPLs • geopolitical uncertainties • <u>BREXIT preparations - continuing supervisory dialogue</u> • <u>2018 EBA-EU-wide and ECB-SSM led stress tests - starting end January 2018 which for Banking Union will inform 2018 SREP settings to be applied in 2019</u> • <u>structural economic challenges in the Eurozone (including fiscal imbalances and debt sustainability concerns)</u> • the growth outlook in emerging market economies • BUSIs' reactions to new regulatory initiatives • developments in residential and commercial real estate markets • repricing of risk in financial markets • cybercrime and IT disruptions • cases of misconduct • non-bank competition • <u>the potential failure of a central counterparty and a rigid business environment</u>

The 2018 Supervisory Priorities will likely have varying degrees of impact. As in previous years, BUSIs are reminded of the importance of complying with a number of detailed provisions set out in what is labelled as ECB-SSM supervisory guidance. These are drafted in a manner that set clear supervisory expectations and in many ways read like rules. The ECB-SSM's actions in relation to NPLs and the publication of the ECB-SSM Guide led to a marked shift in supervisory engagement between ECB-SSM and directly supervised BUSI. With the ECB-SSM now announcing a move to actually police compliance with its NPL Guide and with the EU's 2017 Action Plan on NPLs⁷ suggesting that the European Banking Authority roll-out the NPL Guide in a suitably tailored manner that would prompt compliance for all EU credit institutions the time for actual action is now.

Importantly, the ECB-SSM's rulemaking activity during 2017 continued to embrace an approach whereby supervisory guidance *qua* rules led to these firstly applying to those BUSIs that are subject to direct ECB-level SSM supervision prior to being rolled out to the wider body of BUSIs that are categorised for SSM purposes as "less significant institutions" (LSIs) and thus subject to indirect ECB but direct national authority level SSM supervision. This was the case in respect of rules, supervisory expectations as well as the "soft law" that is framed as "non-binding supervisory guidance", but which is quite clear that it is subject to a "comply and explain" standard and very much reads like rules. In many ways, this process, whilst possibly sensible, in ensuring that the Single Rulebook, as applied within the Banking Union, yields to a more level playing field, means that all BUSIs, regardless of who supervises them directly, may need to increasingly take note of the ECB-SSM's output.

Against that process of rolling-out guidance *qua* rules, the ECB-SSM performed a number of harmonisation exercises. These focused on streamlining legal and regulatory provisions in EU law and notably in respect of provisions where various national options and discretions were implemented or capable of being implemented in Eurozone Member States. The exercise of such national options and discretions elimination (**NODE**) aims to create, preserve or further cement a "level playing field". During the course of 2017 this notably resulted in a more streamlined "CRD IV/CRR+" being implanted first to the ECB-SSM direct supervised BUSIs and then rolling out those NODE items, proportionately, to LSIs. If this style of rulemaking continues, as we anticipate, then it is conceivable that a number of further "change the business", "run the business" and "change the compliance" workstreams will be affected by these Banking Union specific requirements for all types of BUSIs.

SREP in 2018

In relation to SSM SREP developments, it should prior to delving into the implications for 2018 be noted that the ECB-SSM has committed to the SSM's SREP methodology being rolled out⁸ to those BUSIs that are categorised as LSIs. The ECB-SSM has tailored this and harmonised it when applied within the Banking Union (**SSM-SREP**).

⁷ See our coverage in: http://www.bakermckenzie.com/-/media/files/insight/publications/nl_germany_euactionplan_jul17.pdf?la=en

⁸ See our coverage from August 2017 in: http://www.bakermckenzie.com/-/media/files/insight/publications/2017/08/al_germany_srep_aug17.pdf?la=en

Since 2015 the SSM began applying a common and harmonised SSM-SREP methodology in respect of those BUSIs that for SSM purposes are categorised as "significant credit institutions" (**SCIs**). 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. The roll-out of the SSM-SREP from SCIs to LSIs takes this much further.

Within the Banking Union, SREP findings are communicated annually as a supervisory "Decision" i.e., a legal instrument of the ECB-SSM to recipient firms. The Decision stipulates quantitative and qualitative requirements and remedial action plans for the coming annual supervisory cycle. In terms of cost, the SSM-SREP Decisions set what 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.

The outcome of the 2017 SSM-SREP exercise saw that risks were fairly stable but has nevertheless set 39 BUSIs with qualitative liquidity related measures, 2 with both qualitative and quantitative measures and 2 with only quantitative liquidity measures. 84 BUSIs were given 84 qualitative measures covering a range of weaknesses, notably in respect of NPLs, lack of internal governance, IFRS 9, BCBS 239, data quality, operational risk failings and measures resulting from the IRRBB exercise. ICAAP and ILAAP deficiencies were specifically highlighted as grounds for improvement.

So what next?

Whilst the 2017 Methodology Booklet may be familiar reading for SCIs, the fact that the SSM-SREP roll-out is underway will likely make it of very interesting reading for LSIs. This will probably be the case, even if the ultimate roll-out will permit proportionality and supervisory discretion to ensure supervisory convergence and fair treatment of LSIs. For a number of LSIs this will mean improving their resourcing to meet standards to be applied to them.

For SCIs, faced with remedial actions from the SSM-SREP and a full list of impacts heading their way not only from the 2018 Supervisory Priorities but other global, EU, Eurozone and national driven changes, they may want to engage strategically with a mix of some "quick wins" and precautionary action in light of the 2018 Supervisory Priorities, notably in relation to NPLs, improvements to governance, risk, control functions and internal audit (which we understand will receive specific scrutiny, including in respect of BREXIT-readiness), IT and cyber risks as well as the SPoRs. SCIs might equally want to assess how best to advance their FinTech and digitisation exercises as these will play a heightened role (irrespective of PSD2) on the SSM-SREP and on-going focus on business models and profitability.

Even if BUSIs, notably SCIs might be forgiven to think that the similarities of the supervisory priorities for 2018 mean these are no different to those of the preceding years, the outcome for 2018 could be very different. This is due to the fact that the ECB-SSM has grown. Despite some continued shortcomings and

published areas of improvement it is now overall a more confident supervisor in terms of its rulemaking and policing of those rules. It is also increasingly changing its tone in certain communications and open to pragmatic dialogue where it can.

The ECB-SSM now quite crucially has a far greater breadth of supervisory tools at its disposal. That trend will likely continue to expand as the Europeanisation of financial service regulation continues across the Eurozone and its Banking Union even in light of certain critical comments from a handful of national supervisory authorities.

Moreover as the ECB-SSM continues to embed a common supervisory culture across the various ECB and national level components this Europeanisation along with possibly some efficiencies could actually benefit BUSIs in applying more of a single compliance strategy when looking at the Banking Union. Lastly, whilst allocation of budget remains an issue, human capital has begun to gather a requisite amount of field experience and with knowledge capture and retention improving over time the lessons learned in certain areas are being transposed as human capital rotates into new supervisory relationships. In summary, 2018 will be busy for BUSIs and supervisors alike, but it may also lead to real advances in a level playing field and thus convergence of rules, interpretations and approaches and thus more cost efficiency for BUSIs.

If you would like to receive more analysis from our wider Eurozone Group or in relation to the topics discussed above, including what the ECB-SSM's 2018 actions and wider Eurozone changes mean for your business and that of your counterparties then please do get in touch with any of our Eurozone Hub key contacts below. Our Eurozone Hub and the wider Eurozone Group have specific expertise in helping clients along a number of key pending points of supervisory engagement, notably on how to meet ECB-SSM expectations on NPLs or in relation to digitisation projects and the related internal governance, risk and control functions which are some of the core 2018 remedial action points and continued area of ECB-SSM supervisory focus.

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ⁱ See:

https://www.bankingsupervision.europa.eu/ecb/pub/pdf/publication_supervisory_priorities_2016.en.pdf?024a0072fe923441556e5bba7251dd6d

ⁱⁱ See:

https://www.bankingsupervision.europa.eu/ecb/pub/pdf/publication_supervisory_priorities_2017.en.pdf?ac63ee34433643f0d7c8eea5a688327c

ⁱⁱⁱ See: <https://www.bankingsupervision.europa.eu/press/pr/date/2017/html/ssm.pr171009.en.html>

^{iv} See our Background Briefing: http://www.bakermckenzie.com/-/media/files/insight/publications/2017/10/ar_germany_backgroundbriefing_2017.pdf?la=en

^v See our coverage: <http://www.bakermckenzie.com/en/insight/publications/2017/08/consultation-launched-on-draft-ecb-ssm>

^{vi} See our coverage: http://www.bakermckenzie.com/-/media/files/insight/publications/2017/08/al_germany_consultationlaunched_20170810.pdf

^{vii} See our coverage: http://www.bakermckenzie.com/-/media/files/insight/publications/al_germany_ecbssmtighttemssupervisory_oct17.pdf?la=en and subsequent coverage

^{viii} Ahead of that, the following makes for good background reading on policy approaches:

https://www.bankingsupervision.europa.eu/ecb/pub/pdf/170220letter_nouy.en.pdf