RegCORE Client Alert

Financial Services: Revisiting the ECB-SSM's Final Guide on its supervisory approach to consolidation

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QuickTake

On 12 January 2021, the European Central Bank (**ECB**) acting in its role at the head of the Banking Union's Single Supervisory Mechanism (**SSM**) published its long-awaited details and supervisory expectations in the form of a "Guide on the supervisory approach to consolidation in the banking sector" (the **SSM M&A Guide**).[1] The publication followed a consultation process that closed in October 2020 accompanied by a feedback statement, which is useful for framing the context of the final version.[2]

The final version of the SSM M&A Guide now in force clarifies that:

- the use of supervisory tools by the ECB-SSM to facilitate sustainable consolidation projects;
- credible business and integration plans are not penalised with higher capital requirements (Pillar 2 capital);
- temporary use of existing internal models, subject to a strong roll-out plan and governance will be accepted

The ECB-SSM has reiterated that it is now, more so than ever, important to have a strong banking sector to provide resilient and reliable funding to the European economy. This is crucial in supporting the EU's efforts in delivering on its digital transition aims and the Green Deal. In the longer term, the ECB-SSM considers that consolidation is seen as a means to redress structural issues, such as overcapacity and low profitability in the European Banking sector.

It is conceivable that the SSM M&A Guide may be updated further in the future so as to accommodate new developments but also to drive greater supervisory coordination and convergence amongst Banking Union authorities including across the wider European System of Financial Supervision. One key critique that was

1 Available here.
2 Available here.

expressed clearly (and indeed rightly) by a number of commentators during the feedback process of too many authorities acting as obstacles, in particular to cross-border consolidation.

This Client Alert considers the objectives and requirements in the SSM M&A Guide, in particular given that it will likely be of interest for Banking Union supervised institutions and other non-Banking Union and/or non-EU financial services providers, as well as corporate finance advisors, looking to seize opportunities as EU-27 financial services policymakers begin to plan for beyond the pandemic in 2022 and beyond.

Key takeaways from the SSM M&A Guide

Scope

The SSM M&A Guide marks the clearest sign of support by the ECB-SSM for further consolidation in the Banking Union and it also marks an evolution in its institutional mandate. The final guidelines also provide better certainty in how future deal activity might be viewed in the SSM context and by the ECB in its SSM supervisory expectations.[3] Importantly the SSM M&A Guide distinguishes between how it applies to directly ECB-SSM and indirectly ECB-SSM supervised BUSIs. The SSM M&A Guide does not apply to BUSIs under resolution.

In the ECB-SSM's view, consolidation can remove excess capacity (notably as many BUSIs operate too domestically), enhance cost efficiency and promote more focused and credible business models. Equally cross-border consolidation supports greater risk diversification and contributes to financial market integration – a core objective of the Banking Union.

The SSM M&A Guide equally marks a move by the ECB-SSM to pull all of the supervisory principles, including those in its own (internal) Supervisory Manual, that are applicable to M&A and consolidation transactions into a central and core set of guidelines, that set out supervisory expectations for firms. It is also relevant for national authorities in the Banking Union. Specifically, it states (para. 3.) "This Guide should enhance the transparency and predictability of supervisory actions and help credit institutions design prudentially sustainable projects".

The SSM M&A Guide covers the following themes:

1. The overall approach to the supervisory assessment of relevant transactions/projects related to banking sector consolidation (the **Relevant Transactions**);[4]
2. The supervisory expectations related to the Relevant Transactions and execution risk i.e., the risk that a Relevant Transaction is not executed (including as planned) or is not completed due to financial or non-financial factors, including challenges of competing cultures as well as IT systems;
3. The supervisory approach to key prudential aspects of the Relevant Transactions;
4. The ongoing supervision of the newly combined entity including how to move the new entity to the ECB-SSM's administered Supervisory Review and Evaluation Process (**SREP**), which is a core supervisory tool; and
5. The application of the SSM M&A Guide to those BUSIs that are for Banking Union supervisory purposes are categorised as "Less Significant Institutions" (**LSI**s) and thus indirectly supervised by the ECB-SSM and directly supervised by the relevant national competent authorities (**NCA**s).

General considerations

The ECB-SSM's role in banking sector M&A i.e., consolidation, depends on the type of transaction BUSIs choose. If the transaction involves or implies an acquisition of a "qualifying holding"[5] or the creation of a new BUSI, and/or the proposed transaction involves BUSIs that qualify as significant and the law in the respective

[3] As in the draft version of the SSM M&A Guide, the final version is drafted and do read more as expectations as opposed to, as has been the case in other guidelines that do read more like rules. That being said, the draft and final versions in contrast to other ECB(-SSM) publications refers to paragraph numbers with the symbol "§", which in most civil law jurisdictions but also in the United States is used for referencing individually numbered sections of a document but more traditionally used when citing sections of a legal code. We assume that this is a mere coincidence, as it does not fall within the EU institutions (Intra-institutional Style Guide) and thus the drafting style of the ECB(-SSM).

[4] This includes circumstances where one or more BUSIs merge as well as proposed acquisitions of one BUSI by another BUSI. The SSM M&A Guide also applies, with certain adaptations for cases when a non-bank or a non-BUSI is involved.

[5] Every acquisition of a participation in a bank that represents 10% or more of the shares and/or voting rights in that bank or crosses other relevant thresholds.

Banking Union Member States grants powers[6] to the supervisor to approve a merger or similar transaction, then the ECB-SSM will have a formal role as the ultimate decision-making authority for Banking Union regulatory and supervisory purposes. The same applies where the new entity requires a new license to operate as a BUSI.

As part of the ongoing supervision of the firms, the ECB-SSM reviews any proposed Relevant Transaction and assesses whether the proposed acquirer of the qualified holding satisfies the criteria set out in the Capital Requirements Directive (**CRD I**I), as applied in the relevant Banking Union Member State. This includes:

Reputation of the proposed acquirer	Does the proposed acquirer have the necessary integrity and trustworthiness, e.g., no criminal records or court proceedings? Does the acquirer have sufficient professional competence, i.e. their track record in managing and/or investing in the financial industry.
Reputation and experience of the new proposed senior management	Does the acquirer intend to implement changes to the BUSI's managing bodies? If so, a fit and proper assessment of the new board members must be carried out.
Financial soundness of the acquirer	Is the proposed acquirer able to finance the proposed acquisition and maintain a sound financial structure for the foreseeable future? This is assessed in the context of examining the credibility of the business plan and the ability of the target BUSI to ensure continued compliance with supervisory requirements.
Impact on the BUSI	Will the BUSI still be able to comply with prudential requirements? For example, a BUSI should not be put under stress because part of the acquisition was financed by debt. Also, the structure of the acquirer should not be so complex as to prevent the supervisor from effectively supervising the BUSI.
Risk of links to financial crime, money laundering or terrorist financing	Can it be verified that the funds involved are not the proceeds of criminal activity or inked to terrorism? The assessment also looks at whether the acquisition could potentially increase the risk of money laundering or terrorist financing.

While the ECB-SSM does not review or assess whether consolidation efforts or a Relevant Transaction is beneficial as such, it does assess the viability and sustainability of the Relevant Transaction and whether the resulting entity is able to comply with all prudential capital, liquidity, solvency and regulatory conditions (including buffers) for the foreseeable period.

Business model viability and regulatory capital expectations

Business model analysis forms a core part of the SSM's viability and resilience assessment as does a review of proposed governance arrangements and appropriateness of the "strategic steering" for the resulting entity. Notably, the SSM M&A Guide in Section 2.1 states that a credible and comprehensive group-wide business plan, in the eyes of the ECB-SSM, must be plausible, based on prudent and consistent valuation of past transactions/assets, adjusted by an appropriate "margin of conservatism".

It also states that the plan must:

1. be based on "conservative assumptions" (without defining what conservative is), "appropriately justified and documented, founded on data and experience, and is consistent with microeconomic and macroeconomic assumptions that form the baseline scenario and at least one adverse scenario." This requirement in part follows the approach taken from the ECB-SSM's rules on business model assessment as part of licensing approvals;
2. explain how the initial balance sheet and profit and loss projections of the combined entity can be reconciled with the current situation of the entities involved in terms of the capital position, business structure and strategy and profitability. In other words, the ECB-SSM expects to see evidence that the

[6] In Germany, Luxembourg and some other jurisdictions, the national supervisor (currently) does not have the power to approve mergers. In contrast, in Italy, Greece, Slovenia and Belgium for example, the national supervisor has the power to approve mergers or is involved in the approval process. The ECB-SSM as ultimate decision-making authority is involved either in exercise of national powers (where they exist) or as part of on-going supervision.

resulting entity is stronger following the conclusion of the Relevant Transaction than immediately prior to it;

3. detail the composition of the main profitability drivers, which are expected to remain well diversified and balanced in order to avoid overly optimistic assumptions regarding the contribution of non-recurring profits or of non-core or volatile income items;
4. define short, medium and long-term achievable targets and gives details on the roadmap and timeline to achieve those targets; and
5. establish, in a reasonable manner, full compliance with applicable regulatory requirements, supervisory measures and expectations and macroprudential buffers.

The ECB-SSM's supervisory expectations on governance and the risk management framework are that the resulting entity follow applicable EU rules on internal governance, as adapted in order to manage possible integration challenges in a clear way. This is discussed in further detail below. Equally, for Pillar 2 capital requirements (**P2R**) and Pillar 2 Guidance (**P2G**)[7] the ECB-SSM states in Section 3.2 how it would assess the approach for calculating post-completion P2R and P2G requirements following a thorough assessment and, in addition to taking the weighted average of the P2R and P2G levels applicable to the respective entities prior to the consolidation, setting levels that mitigate the main weaknesses of the combined entity and of the execution risk in the business plan.

The ECB-SSM, working together with the Single Resolution Board (**SRB**), can adjust these calculations upwards or downwards depending on the assessment and the relevant risk profile, in order to ensure the stability of the business for at least a year following completion of the Relevant Transaction. The SRB will work together with the ECB-SSM to set appropriate loss absorbency in the form of a minimum requirement of own funds and eligible liabilities (MREL) and total loss-absorbing capacity (TLAC) requirements.

Governance and risk management expectations

The SSM M&A Guide in Section 2.2 sets out its supervisory expectations on governance and risk management structures of the business combination. This includes compliance with existing legislative and rulemaking instruments as a matter of EU law including those of the ECB-SSM and comparable instruments of the European Banking Authority, as adopted by the ECB, each as amended.

Specifically, the ECB-SSM expects evidence (and will monitor) that:

1. at the level of the management body,[8] there is a clear decision-making capacity, adequate composition (for example, in terms of adequate expertise, time commitment, appropriate size and, where applicable, the inclusion of independent members) – this is in keeping with existing rules on fitness and propriety assessments that were updated with effect from 1 January 2022;
2. the other governance arrangements of the business combination establish a clear allocation of responsibilities and decision-making processes for the new structure of the group, along streamlined management body structures and managerial reporting lines;
3. a strong leadership team is in place with a proven track record in both the relevant banking business areas and mergers and acquisitions, as well as in the management of financial and non-financial risks, such as anti-money laundering and countering the financing of terrorism risk, and which pays due attention to the integration of different risk cultures. the consolidation plan includes the timely integration of the risk management and internal control framework, in particular the mitigation of execution risk. The implementation of the plan should be managed and closely monitored by the management body in its management function, with strong oversight by the supervisory function, either in the management body or in any other specific body. Given the operational importance of IT integration, the plan should clearly articulate the governance of the integration process and should be overseen by management body members with adequate expertise;[9] and
4. the execution of the business combination is expected to be governed by adequate remuneration schemes in order to set the right incentives. Variable remunerations should be linked to and conditioned by some risk factors, for example key performance indicators linked to the milestones set out in the integration plan.

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7 The Pillar 2 Requirement (P2R) is a capital requirement which applies in addition to and covers risks which are underestimated or not covered by the minimum capital requirement (known as Pillar 1) applicable to BUSIs. P2Rs are binding and breaches can have direct legal consequences for banks. The P2R is determined via the SREP as administered in the Banking Union. The capital demand resulting from the SREP also includes the Pillar 2 Guidance (P2G), which indicates to banks the adequate level of capital to be maintained to provide a sufficient buffer to withstand stressed situations. Unlike the P2R, the P2G is not legally binding.

8 The SSM M&A Guide clarifies that the term "management body" applies to the bodies in all governance structures that perform management or supervisory functions.

9 The SSM M&A Guide cross-refers to a further supervisory statement available here.

The ECB-SSM confirms in the SSM M&A Guide that its supervisory expectations remain subject to the proportionality principle, which should also be taken into account when weighing up the level of detail that can already be provided in the early communication phase against the complexity of large-scale IT integrations or major IT overhaul plans.

Goodwill and badwill expectations

The SSM M&A Guide details in Section 3.3. the SSM's approach on goodwill and negative goodwill, i.e. badwill[10]. The ECB-SSM will recognise duly verified accounting badwill from a prudential regulatory perspective, expecting it to be used to increase the sustainability of the business model of the combined entity.

This can be achieved, for example, by increasing the provisioning for non-performing loans/exposures (collectively NPLs), to cover transaction or integration costs, or other investment. The ECB-SSM clarifies that it generally expects that the potential profits from badwill will "not be distributed to the shareholders of the combined entity until the sustainability of the business model is firmly established." The ECB-SSM clarifies that this is without prejudice to any special treatment provided for under national company laws.

Timelines and engagement

As a general observation, the ECB-SSM will, in its review and assessment, apply a case-by-case approach based on proportionality of the application of its rules as well as those set out in the SSM M&A Guide. As set out in para. 7, the supervisory assessment and related engagement can encompass up to three phases, namely early communication, application and implementation. Specifically, the implementation phase is subject to close supervision and enhanced monitoring of the newly combined entity. In case of materialisation of execution risks, such as delays or shortcomings in the business combination the ECB-SSM states in para. 13 that a supervisory response can be expected. Further details of this are set out in Sections 4.1 and 4.2 of the SSM M&A Guide, including when to rotate a new combined entity out of enhanced monitoring during the integration plan into the normal Supervisory Examination Program (SEP) and SREP process – in a timely manner.

The ECB-SSM encourages parties considering a consolidation activity in the Banking Union to engage with it as early as possible in the process, so that it can provide preliminary feedback on whether or not a formal decision to approve the Relevant Transaction will be needed. This is without prejudice to the rules set out in the EU's Market Abuse Regulation and instead the guidance focuses on informing the supervisor about key characteristics of the Relevant Transaction backed by robust, credible and informative firm-wide or groupwide integration plans. This is necessary so that the ECB-SSM can complete its preliminary assessment, move to granting authorisation (if required), and monitor integration (including an integration plan) during the implementation phase.[11]

Outlook

Welcomingly what the SSM M&A Guide does not do is fundamentally alter how M&A and consolidation transactions in the Banking Union are structured and executed. This also extends to not impacting how and when existing concepts and requirements concerning regulatory notifications such as qualifying holdings and concurrently possibly obtaining competition law clearance.

What it does do is provide greater regulatory certainty in supervisory expectations. Notably, the final version of the SSM M&A Guide is certainly quite comprehensive, especially when compared to the draft version) in terms of what the ECB-SSM will expect to see and how it will act. This certainly assists in creating a more harmonised chapter to this part of the EU's Single Rulebook as applied in the Banking Union. This in turn creates greater certainty for market participants looking at seizing opportunities in 2022 and beyond.

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[10] Which occurs when a company purchases an asset at less than its net fair market value.

[11] Footnote 8 of the SSM M&A Guidelines states that: The level of detail expected in the integration plan will take into account the nature of the transaction acknowledging in particular that, in hostile takeovers, the acquiring BUSI has limited information on the target. In this regard, it should also be taken into account that pursuant to para. 8.6 Section 1 the Joint Guidelines on the prudential assessment of acquisitions and increases of qualifying holdings in the financial sector "…the supervisor should not oppose the proposed acquisition on the sole basis of the lack of some required information, the absence of which can be justified by the nature of the transaction, if the information provided appears sufficient to understand the likely outcome of the acquisition…"

About us

PwC Legal is assisting a number of financial services firms and market participants in forward planning for changes stemming from these proposals.

If you would like to discuss any of the developments mentioned above, or how they may affect your business more generally, please contact any of our key contacts or PwC Legal's RegCORE Team via de_regcore@pwc.com or our website.

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