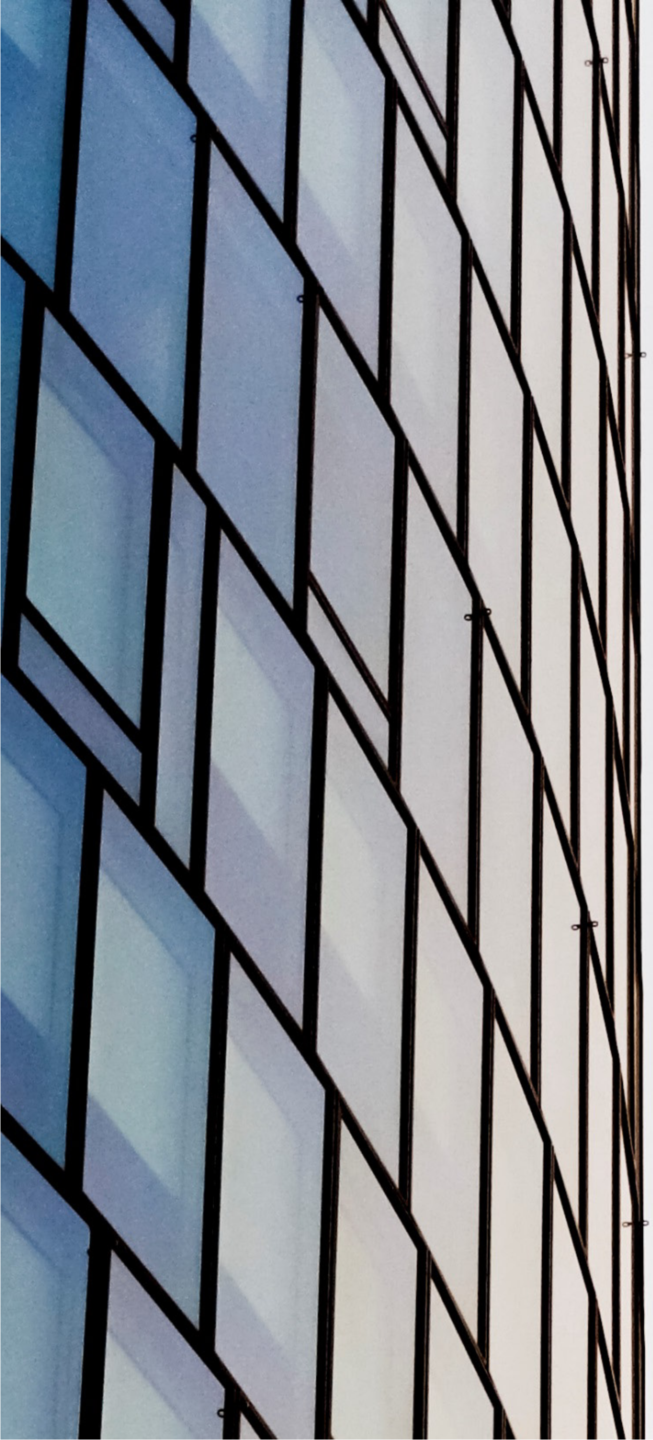

Draft ECB - Guide on the supervisory approach to consolidation in the banking sector

Discussion paper

Frankfurt, July 2020

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1 | Background and objectives

Background and objectives

Background

- **On 1 July 2020, the European Central Bank (ECB) published its Guide on the supervisory approach to consolidation in the banking sector for consultation until 1 October 2020, allowing interested parties the opportunity to comment on the proposed approach by the ECB.**
- The Guide has been published following Andrea Enria’s (Chair of the Supervisory Board of the ECB) announcement during his January 2020 press conference and aims at outlining how supervisors use their powers with respect to consolidation projects.
- In general, the ECB acknowledges the benefits of bank mergers to address low profitability and overcapacity. However, with the Guide the ECB makes aware of supervisory processes and expectations.
- To the ECB it is key that prudential requirements are met at all times also by the merged entity. This applies to capital as well as liquidity buffers. In addition, the business model needs to be viable and sustainable.

Objectives

- **With the publication of this Guide, the ECB aims to clarify how supervisors use their powers with respect to consolidation projects. Greater transparency is intended to make supervisory actions more predictable and avoid misperceptions of supervisory expectations.**
- The ECB outlines how supervisory and prudential tools will be used in order to facilitate sustainable consolidation projects in the European banking sector.
- Furthermore, the published Guide provides guidance how and when to approach the ECB in a SSM bank merger.

2 | Supervisory assessment process

Overall approach to the supervisory assessment of consolidations

Key Objectives		
	1	The newly created entity meets all prudential requirements at all times
	2	Sustainability of the new entity providing outlook for long-term compliance with prudential requirements

Main focus!

ECB considers three main phases

	Early communication phase	Application phase	Implementation phase
Aim	– Obtain preliminary feedback on the project from ECB Banking Supervision – Communication with the ECB before publicly informing market participants	– Obtain project-approval from ECB – Discussion of pre-approval project plan including underlying financials and implementation strategy	– Ensure a progress of post-merger integration in line with the integration plan, in a sustainable manner, and in full compliance with the prudential requirements and conditions
Requirements	– Present the key characteristics of the proposed business combination to ECB Banking Supervision – Provide a robust, credible and informative firmwide or group-wide integration plan	– Submit the formal application for business combination (incl. the business plan, the integration plan, governance arrangements, etc.)	– Close monitoring of the ongoing implementation process – Regular communication with ECB regarding implementation progress
ECB feedback	– Indication whether or not a formal approval will be required – Information on the planned supervisory approach	– ECB Banking Supervision assesses the application and takes a decision on whether or not to object to the notified project within the qualifying holding procedure or to grant a necessary permission under national law – Other necessary supervisory decisions related to business combination	– Enhanced monitoring and supervisory response can be expected in case of materialization of execution risks

3 | Supervisory expectations

ECB's expectations regarding consolidation projects

Sustainable business model & Governance and risk management framework

Submission of a business plan

- The engaging parties are expected to submit a „credible and comprehensive group-wide business plan" with the below characteristics (subject to a case-by-case review):
  - Business Plan based on conservative assumptions consistent with microeconomic and macroeconomic scenarios (baseline and at least one adverse scenario)
  - Providing a clear reconciliation of the projected balance sheet and profit and loss of the planned entity with the latest BS and P&L of the merging entities (in terms of capital positions, business structure, strategy and profitability)
  - Includes transparent targets (short, medium and long-term) and measures for achieving them
  - Demonstrates full compliance with regulatory requirements and expectations (e.g. Pillar 2 requirements and guidance)

Governance and risk management framework

Proportionality principle!

- Management body
  - Clear decision-making capacity and adequate composition (e.g. expertise, independence of members, size)
  - Strong leadership in relevant areas with proven track records (including for management of financial and non-financial risks)
- Organization & Governance
  - Appropriate and clear allocation of responsibilities and decision-making processes
  - Streamlined management and reporting structure
  - The consolidation plan ensures a timely integration of the risk management and internal control framework
  - Proper governance arrangements for the integration process of the IT overseen by the management body
  - Adequate remuneration schemes including variable remuneration linked to risk factors

4 | Supervisory approach

Supervisory approach to key prudential aspects of the consolidation transaction (1/3)

Supervisory approach consists of three main aspects

1	Post-merger Pillar 2 capital requirements (P2R) and guidance (P2G)	2	Prudential treatment of badwill	3	Transitional arrangements for the use of internal models

- **Approach**
  - Starting point will be the weighted average of the P2R and P2G levels applicable to the two entities prior to the consolidation
  - Adjustments necessary in event of insufficient improvement of the risk profile (increase) of the combined entity or effective improvement of the risk profile (decrease)
  - Determination of ex post capital requirements should be clarified during application process
  - Integration plans with credible trajectories for the level of capital in a reasonable manner should be considered (due to high costs booked at the beginning and benefits on the long run)
- **Calculation**
  - Thorough assessment and mitigation of the main weaknesses of the combined entity and of the execution risk in the business plan
  - Appropriate level of Pillar 2 capital, aligned with the risk profile of the combined entity

Supervisory approach to key prudential aspects of the consolidation transaction (2/3)

Supervisory approach consists of three main aspects

1	Post-merger Pillar 2 capital requirements (P2R) and guidance (P2G)	2	Prudential treatment of badwill	3	Transitional arrangements for the use of internal models

- Approach
  - Starting point will be the weighted average of the P2R and P2G levels applicable to the two entities prior to the consolidation

- **Approach**
  - Badwill arises in amount of the difference of the price paid for an entity and the higher book value of its equity
  - ECB recognizes duly verified accounting badwill, unless there is specific supervisory evidence of valuation issues not yet recognized
  - ECB expects badwill to be used to increase the sustainability of the business model of the combined entity (“no free lunch”) e.g. by increasing the risk provisioning or covering integration costs
  - It is expected that arising badwill will not be distributed to the shareholders of the combined entity, until the sustainability of the business model is firmly established (to be defined)
  - ECB will assess the actual use of badwill and its contribution to strengthening the post-merger own funds

Supervisory approach to key prudential aspects of the consolidation transaction (3/3)

Supervisory approach consists of three main aspects

1	Post-merger Pillar 2 capital requirements (P2R) and guidance (P2G)	2	Prudential treatment of badwill	3	Transitional arrangements for the use of internal models

- **Approach**
  - Starting point will be the weighted average of the P2R and P2G levels applicable to the two entities prior to the consolidation

- **Approach**
  - Badwill arises in amount of the difference of the price paid for an entity and the higher book value of its equity

- **Approach**
  - In general, ECB grants approval to use internal models for the purpose of calculating capital requirements to a specific legal entity, and this approval is not transferable to another legal entity (e. g. new entity after consolidation)
  - Subject to a clear model mapping and a credible internal model roll-out plan tackling issues arising through merger, ECB grants a limited period of time in which post-merger entities might continue to use the internal models in place before merger

5 | Post merger ongoing supervision

Overview of the monitoring framework for the new entity

Merger and post-merger monitoring framework

Ongoing monitoring during implementation

- Reporting requirements:
  - Dedicated reporting framework including information on: achieved progress, issues and problems in the key areas (e.g. risk management, compliance, IT, etc.), current state of the roll-out plan, legacy reduction plan
- Supervisory plan
  - Clear and detailed view on the ECBs supervisory program for the new entity including the SREP

"The duration of the enhanced monitoring phase will be based on the timeline of the integration plan"

Post merger convergence with standard supervisory activities

- ECB's target
  - Balance between sufficient time for completion of the integration and simultaneously timely return to standard supervision (regular SREP)
- Approach for entities previously under ECB Supervision
  - In case the merging parties were under the ECB's supervision, the first regular SREP will not increase in additional own funds, unless it is evidenced that additional risks are present and not sufficiently covered
  - Qualitative and quantitative requirements other than P2R and P2G, such as liquidity, will also be reviewed and adjusted if needed
- Approach for entities previously <u>not</u> under ECB Supervision
  - The own fund decision is issued simultaneously with the business combination authorization (where such authorization is needed)
    - The initial capital requirements would then be expected to remain stable in the next SREP, provided there are no new substantial developments during the implementation phase
- LSI's
  - ECB's competence of concerning LSIs is limited to business combinations requiring an assessment of a proposed qualifying holding notification
  - National Competent Authority have competence for merger approvals when provided for by national law

6 | Key takeaways

Main points

The ECB clarifies that as long as projects are based on a credible business and integration plan, improve the sustainability of the business model and respect high standards of governance and risk management at all times, the ECB will:

- Not penalize credible integration plans with higher capital requirements
- Recognize duly verified accounting badwill, expecting it to be used to increase the sustainability of the business model of the combined entity instead of being distributed to shareholders
- Accept the temporary use of existing internal models, subject to a strong roll-out plan.

The Guide re-iterates that any merger should be discussed with the ECB early on, before any public disclosures. This discussion should be well prepared to demonstrate the benefits of the merger, the compliance with regulatory and prudential requirements at all times and the sustainability of the business model.

KPMG'S point of view

From a market perspective, it is highly appreciated that the ECB is increasing transparency and intends to make supervisory actions more predictable and avoid misperceptions of supervisory expectation.

The described process and the planned approach should be seen as clarification of already existing circumstances that are only outlined to increase transparency and not as intention to implement new regulations or supervisory tools.

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