ALLEN & OVERY

Overview of Eurozone banking supervision for non-EU investors

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Banking supervision in the Eurozone

Banking regulation in the Eurozone, as one of the largest banking markets in the world, has been transformed in the aftermath of the 2008 financial crisis and subsequent euro crises. EU member states agreed on the establishment of a banking union as of 2014. This involved the transfer of key supervisory competences to the ECB as part of the Single Supervisory Mechanism (SSM) and establishment of the Single Resolution Board (SRB) responsible for banking resolution as part of the Single Resolution Mechanism (SRM).

The structure of Eurozone banking regulation

Single Supervisory Mechanism

All 19 Eurozone countries (plus Bulgaria and Croatia since 2020) participate in the SSM, which is the first and central pillar of the banking union. The SSM consists of the ECB and the National Competent Authorities (NCAs).

Through the SSM Regulation (SSMR) the ECB has been awarded powers as a single Eurozone supervisory authority with real investigatory and enforcement powers over banks. Subject to the SSM are such banks that qualify as credit institutions under the CRR (ie businesses that conduct lending and deposit-taking business or systemic investment firms whose permission includes trading on own account or underwriting and that have total consolidated assets above EUR30 billion).

Under the SSM competences are shared between the ECB and NCAs: the ECB directly supervises credit institutions that are 'significant' (currently 114 banks that either: (a) have assets exceeding EUR30bn; (b) are of particular economic importance for a specific member state; (c) have significant cross-border activity; or (d) have been granted financial assistance through the European Stability Mechanism). The NCAs on the other hand are the direct supervisors of the remaining 'less significant' credit institutions and over which the ECB has an indirect oversight role with the power to overrule the NCAs.

The ECB has exclusive competence for the granting and withdrawal of banking licences and for the assessment of qualifying holdings in a credit institution regardless of its significance. In addition, even in the context of significant institutions the ECB does not operate alone but fulfils its function under the SSM in conjunction with the NCA. In practice that means that the ECB will form a joint supervisory team (JST) per credit institution that comprises of staff from both the ECB and the NCA.

Single Resolution Mechanism

Alongside the SSM the SRM forms the second pillar of the banking union and came into force in 2016. It establishes a single procedure for the recovery and resolution of credit institutions that applies across the Eurozone. The SRM is made up of two elements: the Single Resolution Board (SRB), responsible for resolution planning and resolution activity, and a Single Resolution Fund (SRF) into which credit institutions have to pay an annual sum and which is designed to finance resolution action where needed.

The SRB is responsible for resolution planning and resolution action regarding significant credit institutions, with those competences remaining with national resolution authorities for less significant banks. As part of its resolution planning powers, the SRB can require banks to take certain action, including limiting their risk exposures, divesting certain assets and introducing changes to their legal or operational structures.

The SRB also has the power to effect the resolution of a credit institution when the following conditions are met: (a) the credit institution is failing or likely to fail (an assessment that the ECB is to make); (b) there is no reasonable prospect of an alternative solution preventing the failure of the bank; and (c) resolution is necessary in the public interest.

When deciding on resolution action, the SRB has four tools at its disposal:

- Sale of the business whereby assets and liabilities are transferred to a third party
- Establishing a bridge bank controlled by the SRB
- Asset separation whereby certain assets are transferred to an asset management vehicle
- Bail-in whereby equity and debt can be written down and converted

In order to pre-empt resolution, banks are obliged to prepare recovery plans that set out how the institution could restore its viability in a scenario of severe financial stress. These plans are assessed by the ECB for significant institutions and the NCA for less significant institutions.

Licensing requirements

In order to conduct commercial banking business in the Eurozone a licence as a credit institution is generally required. The requirements for authorisations are set out in the Capital Requirements Directive (CRD) that individual member states have transposed into national law. CRD requires minimum harmonisation – that means national law can set additional licensing rules.

Thus, while under the SSM the ECB is exclusively competent to grant authorisations; the application needs to be submitted to the NCA of the member state in which the banking activity is to be commenced and this is then notified to the ECB. The ECB will apply national law transposing the relevant CRD provisions as well as any

specific national requirements. This can give rise to difference in the treatment of licence applications across the Eurozone.

An authorisation procedure usually takes between six and 12 months to complete. However, once a credit institution authorisation has been obtained in one member state it is possible to offer the same banking service across the EU under the EU passport procedure.

Establishing a branch of a non-EU bank

There is currently no EU-wide framework for the regulation of branches of banks with a head-office in non-EU countries (TCB).[1] The CRD merely requires that member states do not apply to such branches provisions resulting in more favourable treatment than that accorded to branches of EU credit institutions. As a result, there is significant scope for variation in the regulatory treatment by the different NCAs.

Across the EU the establishment of a TCB is subject to licensing requirements under national law that are to a large extent modelled on the requirements under CRD applicable to credit institutions.

National regulatory regimes can be broadly divided into two categories: (a) the 'subsidiary-like'; and (b) the branch approach. The first tends to regulate TCBs as subsidiaries applying, to the extent possible, the same requirements applicable to banks under CRR while the latter is based on the fact that the TCB is not a distinct legal entity and thus relies on equivalence of the third-country regulatory regime. These two approaches converge in some member states that, while applying the 'subsidiary-like' approach, also offer a simplified treatment more akin to the branch approach if certain strict regulatory requirements are met.

Relationship with supervisors

Credit institutions operating in the Eurozone can expect to have a close and ongoing relationship with supervisors.

For significant credit institutions the primary regulator is the ECB (that will however cooperate closely with the relevant NCA through the JST). For all banks, significant or not, the ECB is the supervisory authority for licensing and assessing the suitability of shareholders.

Institutions are subject to significant and detailed reporting or notification requirements, with significant institutions reporting directly to the ECB and less significant institutions generally only to the relevant NCA.

The ECB will also conduct day-to-day supervision of significant credit institutions. This will for example involve regular supervisory dialogue, on-site inspections during regular business hours or ad hoc checks in response to special circumstances. As part of the annual in-depth assessment –- the Supervisory Review and Evaluation Process (SREP) – the ECB will carry out an assessment of the risks involved in the business of a significant credit institution.

Ongoing operating requirements

A number of requirements are imposed on the ongoing operation of credit institutions that have been harmonised across the EU under CRR and CRD. They are designed to ensure that client money is kept safe and banks pose no systemic risk. These include in particular:

[1] Please note that the European Commission published a proposal for an amendment to CRD (known as CRD VI) on 27 October 2021 which envisages a harmonised European framework for the authorisation and supervision of TCBs.

Capital requirements

At the core of the ongoing obligations are the regulatory capital requirements under CRR which reflect the internationally agreed Basel standards. The amount of regulatory capital a bank must hold is dependent on its individual risk profile. Such risk is assessed using prescribed approaches under CRR by reference to potential sources of risk, namely counterparty risk, market risk, operational risk and settlement risk. Larger banks have the possibility to use internal models to assess their risk exposure. A breach of the capital requirements is treated very seriously and can lead to the introduction of enforcement measures, including in extreme cases the loss of the banking licence.

Capital buffers

In addition to the capital requirements under CRR, there is a requirement under CRD IV for banks to hold capital conservation buffers of 2.5% of risk-weighted assets, with breaches leading to limits of a bank's ability to distribute dividends and pay variable remuneration. The capital conservation buffers are supplemented by countercyclical capital buffers set by regulators.

Leverage ratio

CRD also sets a mandatory leverage ratio of 3%, comparing a bank's capital to its assets and off-balance-sheet items irrespective of the risk. Because the leverage ratio applies independently of risks, it is intended to serve as a backstop to risk-weighted capital requirements.

Liquidity coverage

Under CRD banks are subject to a binding 30-day liquidity coverage ratio designed to protect short-term liquidity under a market-wide idiosyncratic crisis and a newly introduced net stable funding ratio aimed at covering a stable refinancing of long-term liabilities.

Large exposures

CRR places limits on large exposures in an effort to combat risk concentration. A large exposure is defined as a risk position against a client that represents 10% or more of its eligible capital. Such large exposures must be notified to the regulator. There is also is a cap on a large exposure to a single client or group of connected clients of 25% of eligible capital whereby certain risk exposures can be excluded from the calculation.

Management of banks

Appointment of managers

Credit institutions are required to appoint at least two persons to manage its business. The suitability of the management body is scrutinised by the NCA or by the ECB for significant institutions.

The ECB will assess if an appointee is 'fit and proper', which involves an assessment of whether the person is sufficiently qualified and trustworthy to manage a credit institution.

To make the assessment the ECB will look at five criteria: (a) reputation (ie if the appointee has been involved in certain criminal activity, regulatory breaches or other inappropriate behaviour); (b) experience (ie the theoretical and practical knowledge of the appointee),;(c) conflict of interests and independence of mind (ie if the appointee has personal or financial interests contrary to those of the institution and if the appointee is of such character as to be able and willing to challenge other managers and avoid group-think); (d) time commitment (ie how much time the appointee will be able to dedicate to their role with a certain limit on the number of positions a single person can hold); and (v) collective suitability (ie if the management body as a whole has sufficient skill and experience to perform its functions). In its latest guidance the ECB stressed that knowledge of climate-related

and environmental risks was an essential requirement of collective suitability and it would also look at the diversity of the management body as part of its suitability assessment.

Further information can be found in the EU-wide guidance on suitability assessment by the European Banking Association (EBA).

Remuneration of managers

CRD imposes a cap on the amount of remuneration of certain bank staff, including but not limited senior management. A bonus paid must not exceed 100% of the fixed remuneration. With shareholder approval, a higher bonus can be paid in certain circumstances, but must not exceed 200% of the fixed component. Additional requirements apply as part of the Remuneration Regulation, including the requirement to have remuneration systems oriented towards strategic objectives and certain disclosure obligations. There are, however, national variations on this regime with some member states imposing a stricter regime.

Acquisition and transfer of banking businesses

The acquisition of a 'qualifying holding' (defined in CRR as holding directly or indirectly at least 10% of capital or voting rights in an institution) is also subject to supervisory control. In order to determine an indirect holding a look-through approach is adopted whereby the holdings in the corporate structure are multiplied (eg if a person holds 20% in an entity that holds 50% of shares in a credit institution that would amount to an indirect holding of 10%). If the 10% threshold is reached the potential acquirer must notify the NCA as soon as it has formed an intention to acquire.

That means notification may be necessary quite early on in a transaction, eg when a letter of intent is signed. It may however be advisable to approach the supervisor as soon as possible to get a first sense as to whether there are indications of a negative decision so as to avoid unnecessary costs and reputational damage.

The notification of the proposed acquisition must include all relevant facts and must name the seller(s) of the relevant shares. It must also contain a detailed business plan with, inter alia, a business strategy for the target institution and estimates for the three following full business years post-acquisition.

Under the SSM the ECB is exclusively responsible for each and every assessment of the suitability of a shareholder with a qualifying holding. The NCA will forward all notifications it receives to the ECB. The final decision is made by ECB which closely cooperates with the NCA throughout the process.

The potential acquirer is assessed according to five criteria: (a) reputation; (b) if the management body of the acquirer meets the 'fit and proper' standards; (c) financial soundness of the acquirer; (d) ability of the target institution to comply with prudential requirements following acquisition; and (e) the risk of money laundering or terrorism finance involved in the transaction.

The ECB must make its decision within 60 business days of receipt of the complete application, which may be extended up to a maximum of 90 business days and which time needs to be factored into the overall transaction timetable.

Further information can be found in the EBA Guidelines for the prudential assessment of acquisitions of qualifying holding.

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