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Consultation on **new Banking Union supervisory guidelines** on the approach to consolidation in the European banking sector

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Quick Take

In its clearest sign of support for further consolidation of the European banking sector, the European Central Bank (**ECB**) has published supervisory guidelines on how it will evaluate mergers and acquisitions. The draft guidelines clarify that merging entities may not necessarily be asked for additional regulatory capital. It also sets out the ECB's supervisory expectations as to merging entities' use of their own risk models during an implementation period as well as the permitted degree and use of "badwill". The public consultation period runs to October 1, 2020.

The new supervisory guidelines and expectations do not necessarily represent a lowering of the bar but rather an evolution of the ECB's mandate and ability to drive supervisory priorities to create a more efficient and resilient EU banking sector during the current COVID-19 operating environment and beyond. The new guidelines also provide welcome clarity given how previous deals have been handled and may reduce the perceived regulatory deterrents for future deal activity.

Senior management, compliance, legal and risk teams, but more importantly corporate finance deal teams in banks and potential banking sector investors, will want to take note of the current draft guidelines as well as the breadth of impacts that these new supervisory guidelines and expectations mean for the sector as well as in relation to deal opportunities.

On the eve of what in ordinary times would be the start of the European summer holiday season the European Central Bank (**ECB**), acting in its role at the head of the Banking Union's Single Supervisory Mechanism (**SSM**), published on July 1, 2020, draft guidelines[1] setting out its supervisory approach for consolidation (the **Banking Sector M&A Guide**). The ECB-SSM has invited comments during a consultation period that will run until midnight (CET) on October 1, 2020. Following the end of the public consultation, the ECB-SSM will publish the comments received together with a feedback statement ahead of publishing a final version of the Banking Sector M&A Guide.

This Background Briefing looks at the content of these draft supervisory guidelines and its impact on credit institutions i.e., Banking Union Supervised Institutions (**BUSI**s) and will be supplemented by further analysis once the final version of the Banking Sector M&A Guide is published.

The ECB-SSM's focus on further banking sector consolidation

Despite public concerns about "too big to fail", the consolidation of actors (regardless of their size) in the EU's banking sector has been a long-standing supervisory priority of the ECB-SSM[2]. The prevailing view at the ECB-SSM is that a number of BUSIs across the Banking Union may operate inefficiently and too much within domestic boundaries. Consolidation can, in the ECB-SSM's views, remove excess capacity, enhance cost efficiency and promote more focused and credible business models, while equally cross-border consolidation supports greater risk diversification and contributes to financial market integration – a core objective of the Banking Union.

These views, as supplemented by multiple policy speeches, are also evidenced by relevant working papers on both the ECB-SSM and central banking versions of its website. The Banking Sector M&A Guide in many ways marks a move for the ECB-SSM to pull all of these principles, including those in its own (internal) Supervisory Manual, into a central and core set of guidelines, that set out supervisory expectations[3] 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".

Key takeaways from the draft rules

The Banking Sector 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 Banking Sector M&A Guide to those BUSIs that are for Banking Union supervisory purposes categorized as "Less Significant Institutions" (**LSI**s) which are indirectly supervised by the ECB-SSM and directly supervised by the relevant national competent authorities (**NCA**s) for Banking Union purposes.

[1] Available here.

[2] See analysis of Banking Union, Capital Markets Union and wider EU-27 supervisory and regulatory rulemaking priorities in the latest edition of our annual publication Navigating 2020.

[3] Which are 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 Banking Sector M&A Guide, 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 Banking Sector M&A Guide also applies, with certain adaptations for cases when a non-bank or a non-BUSI is involved.

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 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[7] set out in the Capital Requirements Directive, as applied in the relevant member state of the Banking Union. While the 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 the resulting entity and its ability to comply with all prudential capital, liquidity, solvency and regulatory conditions (including buffers) for the foreseeable period.

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 Banking Sector M&A Guide in Chapter 2.1 states that a credible and comprehensive group-wide business plan, in the eyes of the 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:

- 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;
- Explains 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 SSM expects to see evidence that the resulting entity is stronger following the conclusion of the Relevant Transaction than prior to it;

[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.

[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 decisionmaking authority is involved either in exercise of national powers (where they exist) or as part of on-going supervision.

[7] These criteria include the ECB-SSM and the relevant national supervisor(s) assessing that the following are satisfied:

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 proposed new managers	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 money laundering or terrorist financing	Can it be verified that the funds involved are not the proceeds of criminal activity or linked to terrorism? The assessment also looks at whether the acquisition could potentially increase the risk of money laundering or terrorist financing.

- Details 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;
- Defines short, medium and long-term achievable targets and gives details on the roadmap and timeline to achieve those targets; and
- Establishes 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. Equally, for Pillar 2 capital requirements (**P2R**) and Pillar 2 Guidance (**P2G**)[8] the ECB-SSM states in Chapter 32 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.

Lastly, the Banking Sector M&A Guide details in Chapter 3.3. the SSM's approach on goodwill and negative goodwill, i.e. badwill[9]. The ECB-SSM will recognize 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.

[8] 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.

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

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.

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 Banking Sector M&A Guide. As set out in para. 7 of the Banking Sector M&A Guide, the supervisory assessment and related engagement can encompass up to three phases, namely early communication, application and implementation.

The ECB-SSM encourages parties envisaging consolidation in the banking sector to engage with it early on 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 focuses on informing the supervisor about key characteristics of the Relevant Transaction backed by robust, credible and informative firm-wide or group-wide integration plans. This is necessary so that the ECB-SSM can complete its preliminary assessment[10], move to granting authorization (if required), and monitor integration (including an integration plan) during the implementation phase.

Outlook and next steps

The Banking Sector M&A Guide seeks to create greater certainty for market participants by clarifying the ECB-SSM's approach to takeovers, resolving previously perceived hurdles, and thus encourage greater consolidation. Crucially the Banking Sector M&A Guide makes it clear that the ECB-SSM will generally take an approach so as to:

- Not penalize credible integration plans with higher capital requirements. The starting point for capital will be the weighted average of the two banks' Pillar 2 capital requirements and Pillar 2 guidance prior to consolidation;

[10] Footnote 8 of the Banking Sector 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 Chapter 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…"

- Look to the use of "badwill" by banks for risk reduction and value-added investments; and
- Accept the temporary use of existing internal models, subject to a strong roll-out plan, provided these are subject to a clear model mapping and a credible internal model roll-out plan until all necessary model permissions are in place. These plans should, in the ECB-SSM's view, address the specific internal model issues created as a result of a merger or other Relevant Transaction, and generally avoid any unnecessary supervisory burden linked to undue volatility in risk-weighted assets and reduction in risk sensitivity if BUSIs temporarily revert to the CRR/CRD IV framework's standardized approach.

Regardless of these new regulatory and supervisory clarifications, market participants will want to carefully consider how to comply with key items that are set out in the final version of the Banking Sector M&A Guide, notably given the ECB-SSM's interest in and scrutiny of BUSIs' business models, profit and risk drivers.

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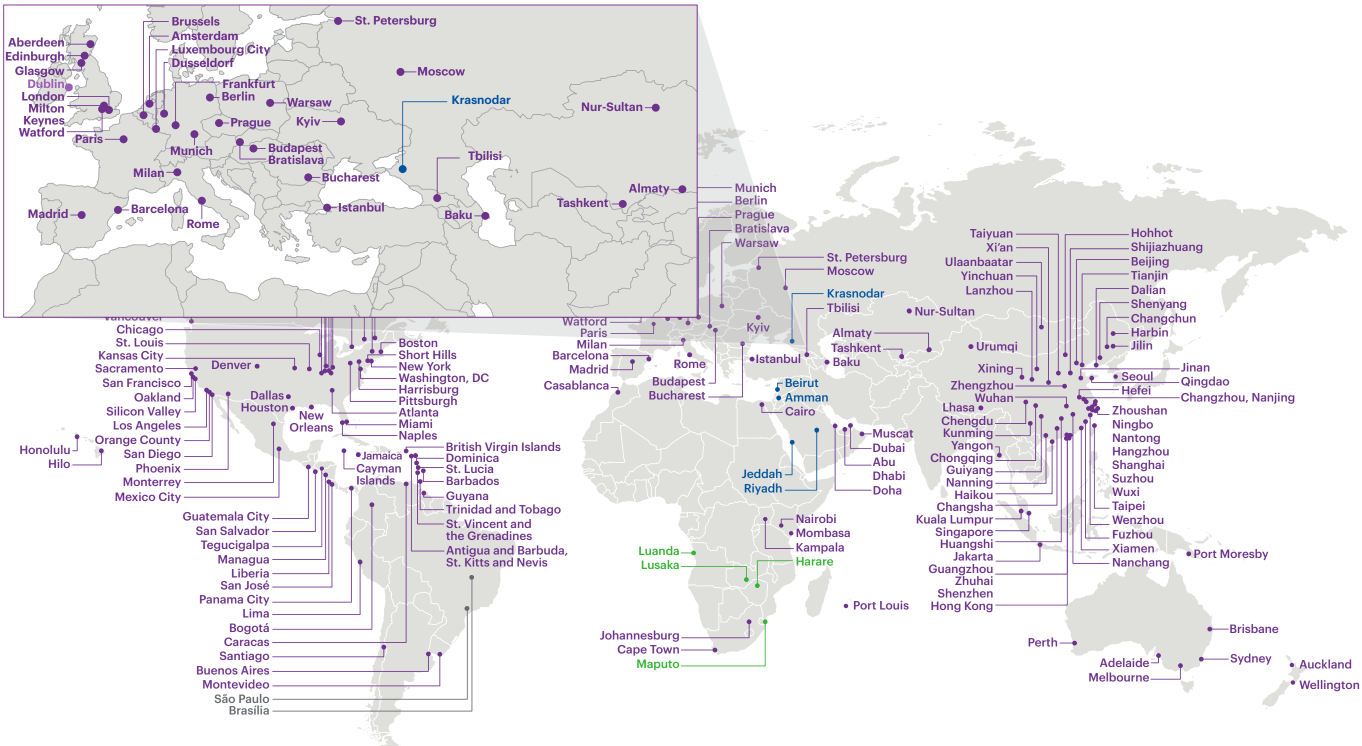
    d. managing and resolving NPLs; and

13. Negotiating contractual, operational and supplier arrangements with third-party service providers.



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