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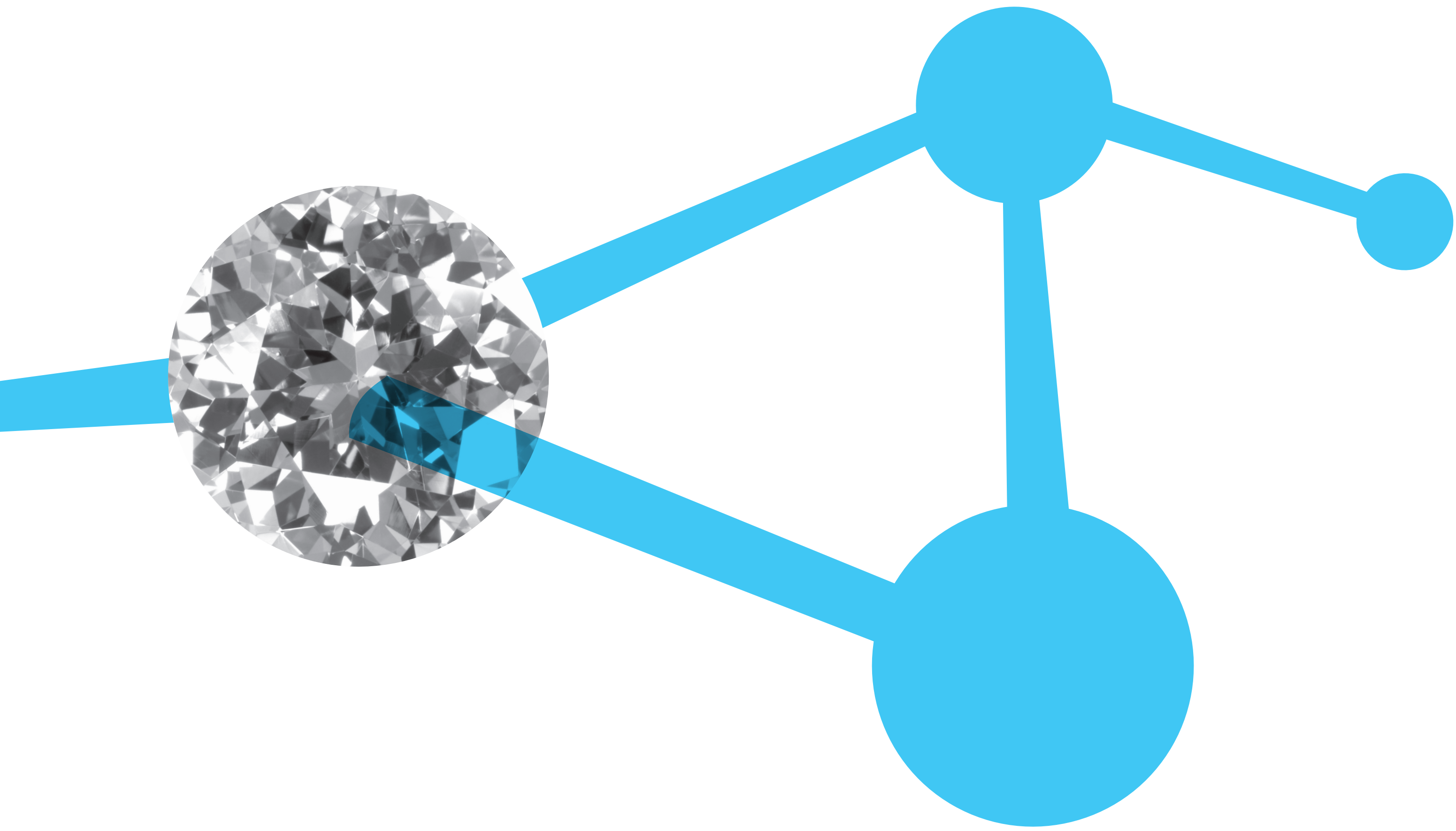
Effective engagement
The Single Supervisory Mechanism
2 years on



Introduction

As noted recently by the IMF, the introduction of the Single Supervisory Mechanism ("**SSM**") in November 2014 "has produced profound changes in the way banking supervision is conducted". The transfer of competences to the European Central Bank ("**ECB**") has given rise to a complex web of interrelationships between the ECB and national regulators for the supervision of banks in the Euro area. Banks need to ensure that they fully understand this relatively new and evolving matrix of relationships so that they engage effectively with their regulator.

Ciaran Walker (former Deputy Head of Enforcement with the Central Bank of Ireland) discusses the complex and evolving roles of the ECB and national regulators in the supervision of banks.

What is the SSM?

At an EU Summit in 2012, in the context of the international financial crisis and subsequent Euro-area sovereign debt crisis, and in order to safeguard the financial stability of the Euro area and protect taxpayers from major bank failures, Heads of State and Government of the Euro area agreed to the establishment of the SSM as a first step towards a Banking Union.

The SSM was established by Council Regulation (EU) 1024/2013 (the "SSM Regulation"), which set out its functions and powers. It is complemented by ECB Regulation (EU) 468/2014 (the "SSM Framework Regulation") which sets out further details. The SSM commenced its functions on 4 November 2014.

As to the aims of the SSM, as noted in a recital of the SSM Regulation:

"As a first step towards a banking union, a single supervisory mechanism should ensure that the Union's policy relating to the prudential supervision of credit institutions is implemented in a coherent and effective manner, that the single rulebook for financial services is applied in the same manner to credit institutions in all Member States concerned and that those credit institutions are subject to supervision of the highest quality, unfettered by other non-prudential considerations."

The SSM Regulation confers supervisory tasks on the ECB for the prudential supervision of credit institutions in the 19 EU countries in the Euro area. It provides that the ECB is to carry out its tasks within an SSM, composed of the ECB and national competent authorities (ie relevant national financial regulators in the Euro area, such as the CBI); the ECB is responsible for the effective functioning of the SSM.

The exclusive tasks conferred on the ECB under the SSM Regulation include:

- the authorisation (and withdrawal of authorisation) of credit institutions
- the review of notifications of the acquisition and disposals of qualifying holdings in credit institutions
- the prudential supervision of credit institutions.

  The ECB exercises direct supervisory jurisdiction over all of the main credit institutions in the Euro countries, categorised as Significant Institutions ("**SIs**") (they are also known as Significant Supervised Entities).

  For all other credit institutions established in the Euro area, which are categorised as Less Significant Institutions ("**LSIs**"), the main prudential regulator is the relevant national authority and the ECB has a limited indirect supervisory role
- deciding on whether an individual meets the "fit and proper" requirements to be appointed to the management body of an SI. This exclusive jurisdiction also applies in the case of reappointments and to appointments to LSIs, where the LSI is also seeking authorisation as a credit institution
- the imposition of fines on SIs for breaches of relevant EU Regulations and Decisions

"Prudential" supervisory tasks of the ECB

The scope of the ECB's role as "prudential" supervisor of credit institutions is open to debate and will benefit from further clarification over time.

The core EU prudential requirements on credit institutions in the EU are set out in Directive (EU) 2013/36 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms ("**CRD IV**") and Regulation 575/2013 on prudential requirements for credit institutions and investment firms ("**CRR**").

The scope of the various requirements set out in CRD IV on internal governance, for example, are capable of being broadly interpreted. Thus, whilst a recital to the SSM Regulation notes that supervisory tasks not conferred on the ECB are a matter for national authorities, and such tasks include consumer protection supervision and anti-money laundering supervision, this does not necessarily mean that the ECB has no role in these areas given the potentially wide scope of its supervisory role in relation to internal corporate governance of credit institutions.

As noted by the chair of the SSM Supervisory Board, Danièle Nouy, in a recent speech in which she emphasised that internal governance was a supervisory priority of the SSM:

> *"While not directly responsible for consumer protection and financial market integrity, we closely monitor the implications of legal, reputational and misconduct cases on banks' governance, culture, compliance, and financial risk profile".*

It may be debated whether systemic breaches of eg consumer protection requirements could also be deemed to amount to breaches of the internal governance requirements of CRD IV.

The 19 SSM countries

How does this prudential supervision work in practice?

Each of the SIs is prudentially supervised on a day-to-day basis by a separate Joint Supervisory Team ("**JST**"), which is composed of staff from both the NCA of the SI in question and staff from the ECB. Whilst the implementation of day-to-day supervisory tasks may largely be performed by NCA staff on the ground in the country in question, each JST is led by a JST co-ordinator based in Frankfurt, who is generally not from the country where the SI is established.

The JSTs carry out very detailed, lengthy and intrusive supervision of the SIs each year, including lengthy on-site inspections. The process, described as the Supervisory Review and Evaluation Process ("**SREP**"), focuses on detailed reviews of the following four key areas: business models, internal governance and risk management, risks to capital and risks to liquidity.

The outcome of the SREP is SREP decisions, separately imposed on each of the SIs, setting out requirements on the SI. The requirements may relate to eg technical aspects of their capital and liquidity or more qualitative issues relating eg to internal corporate governance.

A key aim of the SREP is to ensure that a consistent and rigorous approach is adopted to the prudential supervision of all SIs across all 19 Euro area states. This is facilitated by the decision-making process for the adoption of SREP decisions, which involves draft decisions being approved by the SSM Supervisory Board (which includes senior ECB staff and senior representatives of each of the participating states, typically the head of financial regulation of each national financial regulator) and ultimately adopted by the ECB Governing Council (which includes the President of the ECB, Mario Draghi, and the governors of the national banks of each of the 19 Euro area countries).

A complicating factor, however, in terms of seeking to achieve a consistent approach across all 19 Euro countries is that there is not full harmonisation of applicable rules, as the prudential requirements in CRD IV may be (as an EU Directive), and have been, transposed differently across the 19 Euro countries.

The SREP decisions are appealable decisions and can be appealed to the Court of Justice of the European Union.

SIs are also entitled to refer a SREP decision to an Administrative Board of Review ("**ABoR**") for a full review. The ABoR is composed of "five individuals of high repute" with relevant experience who are not from the ECB or relevant national authorities. The ABoR expresses an "opinion" on the decision in question; the Supervisory Board is required to take into account the ABoR opinion in adopting a new draft decision (which may or may not differ from the original decision), which is deemed adopted unless the Governing Council objects within 10 working days. That second decision is appealable to the Court of Justice of the European Union.

"Fit and proper" reviews

The ECB has exclusive jurisdiction to decide on whether an individual meets the "fit and proper" requirements to be appointed to the management body of an SI. This exclusive jurisdiction also applies in the case of reappointments and appointments to LSIs, where the LSI is also seeking authorisation as a credit institution.

The substantive fit and proper requirements are set out in Art 91 CRD IV (in interpreting these substantive requirements, the Fit and Proper Guidelines and Internal Governance Guidelines, adopted by the European Banking Authority, should also be taken into account). On 28 October 2016, the European Banking Authority and European Securities and Markets Authority issued for consultation draft Guidelines on the suitability of members of a management body and key function holders.

National implementation of CRD IV differs across the 19 Euro states, so both the procedures for approval and the substantive criteria for assessment differ in each state.

CRD IV sets out five criteria for a "fit and proper" assessment of an individual: knowledge, skills and experience; reputation; time commitment; conflicts of interest and independence; collective suitability.

The ECB also has the power to remove an individual from the managing body of a credit institution at any time where it determines that the individual is not meeting the "fit and proper" requirements.

On 14 November 2016, the ECB issued for public consultation its draft Guide to fit and proper assessments.

Enforcement and sanctions procedures

Where there is a continuing breach by a credit institution of a regulation or supervisory decision (eg SREP decision), the SSM Framework Regulation provides that the ECB may impose a periodic penalty payment on the credit institution "with a view to compelling the persons concerned to comply with the regulation or supervisory decision." This power to impose a periodic penalty payment to force compliance is separate from the ECB's sanctioning powers. The periodic penalty payment that may be imposed is up to 5% of average daily turnover for each day of infringement, for up to six months.

Separately, the ECB has exclusive jurisdiction to impose fines on SIs for breaches of directly applicable EU law. Under the SSM Regulation, the ECB may impose fines of up to twice the amount of profits gained or losses avoided because of the breach (where this can be determined) or 10% of total annual turnover in the preceding business year.

The ECB does not, however, have jurisdiction in relation to SIs to impose:

- fines on SIs for breaches of national law transposing relevant EU Directives
- non-monetary sanctions on SIs
- sanctions on individuals in SIs

In each of the above circumstances, it is a matter for the relevant national competent authority to take enforcement action, but only once it is required to do so by the ECB. Thus, under Art 18(5) SSM Regulation, the ECB may "require a national competent authority to open proceedings with a view to taking action in order to ensure that appropriate penalties are imposed".

The ECB has significant investigatory powers under the SSM Regulation eg it can require submission of documents, obtain written or oral explanations from credit institutions and persons working for them, carry out on-site inspections.

In light of the resource commitments involved in such investigations in the 19 Euro countries and the reasonable likelihood that many of the infringements that may arise may amount to breaches of national law transposing CRD IV (whether or not they may also amount to breaches of an EU Regulation, such as CRR), it will be interesting to observe how this interrelationship between the ECB and national authorities develops, in relation to the carrying out of investigations leading to sanctions.

To date there has not been any published ECB sanctions decision.

SSM and corporate governance

Internal governance in credit institutions is one of the stated key supervisory priorities of the ECB. In June 2016, following a thematic review of risk governance and risk appetite in all SIs, the ECB published its findings. It noted that many banks will be expected to improve their internal governance and that:

> *"The SSM will continue fostering the dialogue with the boards through regular meetings and using a string of different tools to assess governance, including on-site inspections, documentation analysis, meetings, ongoing 'fit and proper' tests etc. In addition, SSM supervisors may attend parts of board meetings as observers from time to time to see how the board functions and to convey some specific messages."*

It can be expected that the SSM will further develop its focus on corporate governance in the future. Thus, for example, as noted by the Central Bank of Ireland's Director of Credit Institutions, Ed Sibley, in a recent speech:

> *"It is clear that cultural issues are frequently linked with firm failures, and this was certainly the case in the banking failures in Ireland. The SSM is developing its approach in this area, learning in particular from the leading edge approach in the Netherlands, and we will be undertaking behaviour and culture inspections in the Irish banks in due course."*

The Chair of the SSM Supervisory Board, Danièle Nouy, has in a recent speech stated that "corporate governance, values and culture are at the heart of the SREP" and has identified a number of means by which banks' risk culture will be assessed under SSM, such as reviewing the adequacy of the Risk Assessment Framework and governance arrangements put in place by the bank's board. Also:

> *"Regarding the role of internal controls, we also expect an active and effective internal audit and compliance function to identify and prevent misconduct within the organisation and protect sound risk culture."*

On 28 October 2016, the European Banking Authority ("**EBA**") issued for public consultation "Draft Guidelines on internal governance". These detailed draft Guidelines are intended to update the EBA 2011 guidelines on internal governance. The EBA is mandated by CRD IV to adopt guidelines on internal governance. All credit institutions and investment firms in the EU (ie not just SIs and LSIs within the scope of SSM) are required to make "every effort to comply" with the guidelines once adopted by the EBA.

How Eversheds Consulting can help

Eversheds Consulting is a service from a leading global law firm, bringing together a mix of highly experienced consultants, lawyers, audit and risk specialists to provide tailored consulting services to clients. It has recently expanded further through the appointment of Ciaran Walker, who was previously Deputy Head of Enforcement with the Central Bank of Ireland and who has significant experience of the SSM.

Eversheds Consulting can assist firms to understand and navigate the complex ECB/national authority interrelationships of powers and functions. It can also assist credit institutions in relation to all aspects of internal governance and fit and proper reviews for SSM purposes.

"Regarding the role of internal controls, we also expect an active and effective internal audit and compliance function to identify and prevent misconduct within the organisation and protect sound risk culture."

Danièle Nouy, *Chair of the SSM Supervisory Board*

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