THE SINGLE SUPERVISORY MECHANISM – OUR EXPERIENCE SO FAR

Karol Gabarretta

5 March 2015

Disclaimer: The author wishes to specify that the views expressed within this presentation as well any errors, are his sole responsibility and do not in any way represent the official views of the MFSA nor those of the ECB

OVERVIEW OF THE PRESENTATION

- Introduction – the Banking Union and the rationale for the Single Supervisory Mechanism (SSM)
- The SSM and Framework Regulations – an outline
- The practical implications resulting from the SSM which impact on the conduct of local banking supervision
- Conclusions

INTRODUCTION – THE BANKING UNION AND THE RATIONALE FOR THE SINGLE SUPERVISORY MECHANISM (SSM)

Why was the ECB selected for its pivotal role within the SSM?

- The ECB will ensure a ***truly European supervisory mechanism*** that would not be prone to the protection of national interests and which will ***weaken the link between banks and national sovereigns***
- The ECB's ***strong focus and expertise on financial stability*** should ensure that financial stability risks are sufficiently taken into account
- The ***Treaty on the Functioning of the European Union (TFEU, article 127(6))*** stipulates that supervisory tasks can be conferred on the ECB, *ergo*: "*The [EU] Council, acting by means of regulations in accordance with a special legislative procedure, may unanimously, and after consulting the European Parliament and the European Central Bank, confer* ***specific tasks upon the European Central Bank concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings***"
- Finally, the organisational principles laid down in the legislative package ensure the ***separation*** of the ECB's ***monetary policy tasks*** from its ***supervisory tasks***

INTRODUCTION – THE BANKING UNION AND THE RATIONALE FOR THE SINGLE SUPERVISORY MECHANISM (SSM)

Structure of the Banking Union

Supervision – Single Supervisory Mechanism (SSM)

ECB + NCAs (including MFSA)

- Significant banks (with NCAs' involvement)
- Less-significant banks (NCAs will continue supervising under the overall oversight of the ECB)
- Horizontal functions
- Authorisation
- Planning and coordination of Supervisory Examination Programme
- Enforcement & Sanctions
- Crisis Management
- Internal models' approval

Resolution and Restructuring

Single Resolution Mechanism

- Ensures that if a bank subject to SSM faced serious difficulties its resolution could be managed efficiently with nominal costs to tax payers and the real economy
- Applies to substructure rules of bank recovery and resolution (through BRRD)
- Still to be decided SRA – EU Commission or EU Council?
- Locally – Creation/appointment of resolution authority
- The single resolution mechanism should be based on contributions by the financial sector itself and include appropriate and effective back stops

Deposit Guarantee

Common/Pan-European Deposit Guarantee Scheme? (or something akin to a 'European System of Deposit Guarantee Schemes'?)

- Political obstacles appear to make agreement on the substance unlikely - at this stage at least
- It seems that substantial work may still be required in this area

INTRODUCTION – THE BANKING UNION AND THE RATIONALE FOR THE SINGLE SUPERVISORY MECHANISM (SSM)

Fully-fledged banking union

Single Supervisory Mechanism (SSM)	Single Resolution Mechanism (SRM)	Single Deposit Guarantee Scheme
• Set up to ensure **homogenous supervisory standards** across the euro area. • **ECB** to directly supervise 128 significant banks, representing 85% of total euro area banking assets. • Fully operational on **November 4, 2014** • Beforehand: **Comprehensive assessment** (AQR and stress tests) based on a capital benchmark of 8% Common Equity Tier 1.	• Will enter into force on **January 1st, 2015** • **Single Resolution Board** to be single authority responsible for resolution of euro area banks. • Resolution to be financed by bank's shareholders and creditors (**bail-in** equal to at least 8% of total liabilities, pre-defined cascade of liability) and backed by **Single Resolution Fund** (5% of total liabilities max). • Bail-in and resolution functions to apply from January 1st, 2016. • Fund financed by **bank levies** raised at national level as from 2016 and **gradually mutualized** in the course of 8 years. Volume: EUR 55bn by 2024. Fund could borrow from the market.	• **Not envisaged** at this stage. • Instead: **Harmonized** deposit guarantee schemes as set out in the Single Rule Book (Directive on DGS). • EU savers are guaranteed that their deposits **up to EUR 100.000** (per depositor / per bank) are protected at all times and everywhere in the EU. • Financing requirements for DGS: target level for **ex ante funds of 0.8% of covered deposits** to be collected from banks over a 10-year period.

Based on EU-wide rules for banks, the Single Rule Book, e.g. Directives on Capital Requirements (Basel III) since 2014, Bank Recovery and Resolution (BRRD) and Deposit Guarantee Scheme (DGS) starting 2015.

Banks will no longer be "European in life but national in death".
Bail-in should become the rule, bail-outs the exception.

Source: Allianz GI Global Capital Markets & Thematic Research, as of May 2014

THE SSM AND FRAMEWORK REGULATIONS – AN OUTLINE

- Reference to SSM Regulation here is to: ***COUNCIL REGULATION (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions*** while to Framework Regulation is to ***: REGULATION No 468/2014 of the European Central Bank of 16 April 2014 establishing the framework for cooperation within the Single Supervisory Mechanism between the European Central Bank and national competent authorities and with national designated authorities*** *(SSM Framework Regulation - ECB/2014/17)*
- The Single Supervisory Mechanism (SSM) comprises the ECB and the national competent authorities (NCAs) of participating Member States
- The SSM is responsible for the prudential supervision of all credit institutions in the participating Member States. It ensures that the EU's policy on the prudential supervision of credit institutions is implemented in a coherent and effective manner and that credit institutions are subject to supervision of the highest quality

THE SSM AND FRAMEWORK REGULATIONS – AN OUTLINE

- The SSM's three main objectives are to:
  - ensure the **safety and soundness** of the European banking system;
  - increase **financial integration and stability**;
  - ensure **consistent supervision**

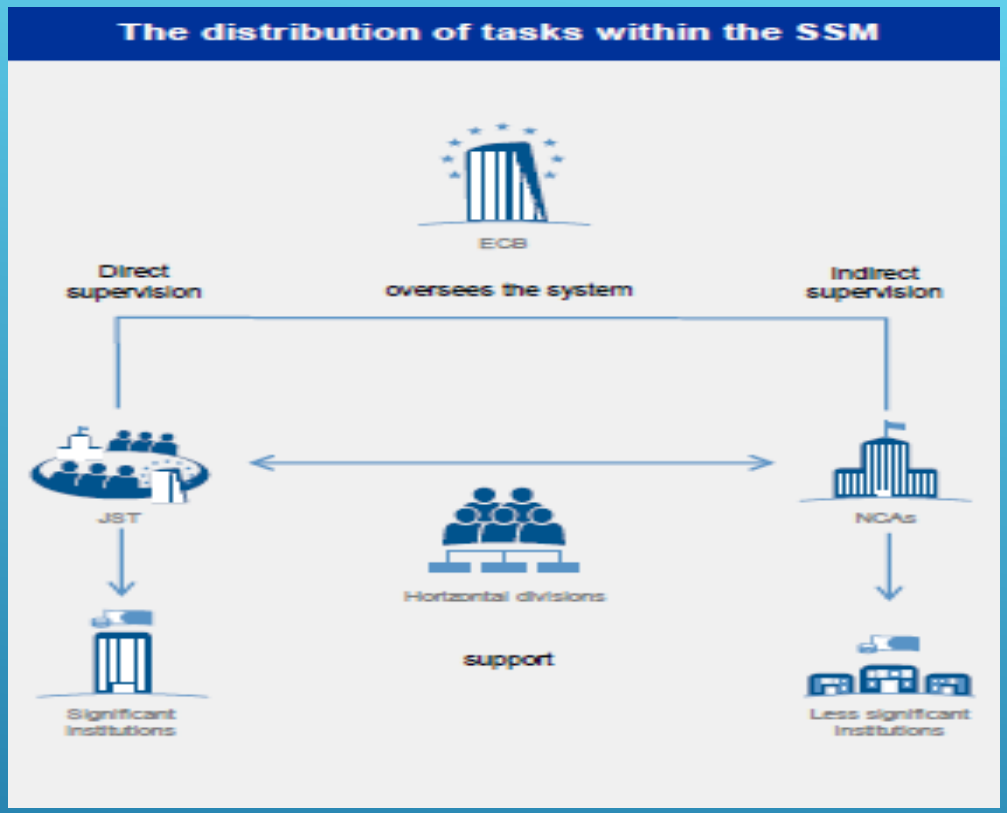
- On the basis of the SSM Regulation, the ECB, with its extensive expertise in macroeconomic policy and financial stability analysis, carries out clearly defined supervisory tasks to protect the stability of the European financial system, together with the NCAs. **Thus the SSM Regulation and the SSM Framework Regulation provide the legal basis for the operational arrangements related to the prudential tasks of the SSM**

THE SSM AND FRAMEWORK REGULATIONS – AN OUTLINE

Supervisory powers - what falls under the remit of the ECB and what doesn't?

- Union law on the prudential supervision of credit institutions (**CRD IV/CRR**) provides for certain powers to be conferred on Member States' NCAs for those purposes. To the extent that those powers fall within the scope of the supervisory tasks conferred on the ECB, ***the ECB shall be considered the competent authority for banking regulation and supervision in participating Member States*** in terms of the said legislation and shall thus have the powers conferred by Union law on the MFSA (and on any other relevant NCAs within the SSM)
- Thus, ***for those areas which lie outside the scope of the SSM Regulation, the MFSA will continue to be the CA for banking*** e.g. in the supervision of ***branches from third countries*** established locally and ***financial institutions licensed in terms of the FIA*** *(the so-called 'Non-SSM' function undertaken by the MFSA's BSU)*
- Moreover, the competent or designated authorities of the participating Member States would still be able to apply ***macroprudential tools not provided*** for in relevant acts of Union law

THE SSM AND FRAMEWORK REGULATIONS – AN OUTLINE



Source: ECB Guide to Banking Supervision November 2014

The ECB is responsible for the direct supervision of around 120 banking groups, which together account for almost 85% of total banking assets in the euro area. Supervised credit institutions that are considered less significant are supervised directly by the relevant NCAs under the overall oversight of the ECB. All credit institutions under the SSM's supervision are subject to the same supervisory approach

THE SSM AND FRAMEWORK REGULATIONS – AN OUTLINE

So who would be in-scope ?

- The so-called "***significant banks***" are in-scope for direct supervision i.e. ECB will directly supervise such banks while national competent authorities shall be responsible for assisting the ECB within such process
- The basic criteria defining significance laid down in the ECB Regulation are:
  - Banks which have requested or received public financial assistance from the European Stability Mechanism (ESM) or the European Financial Stability Facility (EFSF)
  - Total Assets > EUR 30 bn
  - ***Total Assets > 20% of GDP and > EUR 5 bn or if such thresholds are not applicable then the ECB would carry out the tasks conferred on it through the ECB Regulation on:***
  - ***the 3 most significant credit institutions per jurisdiction***
- In this case ***more specific criteria of significance*** would be applicable, namely:
  - ***Size*** - the total value of a bank's assets
  - ***The importance for the economy of the country in which the bank is located or the EU as a whole***
  - ***The significance of the bank's cross-border activities***
- It is evident that in this case the more specific criteria of significance will need to be assessed on a case-by-case basis

THE SSM AND FRAMEWORK REGULATIONS – AN OUTLINE

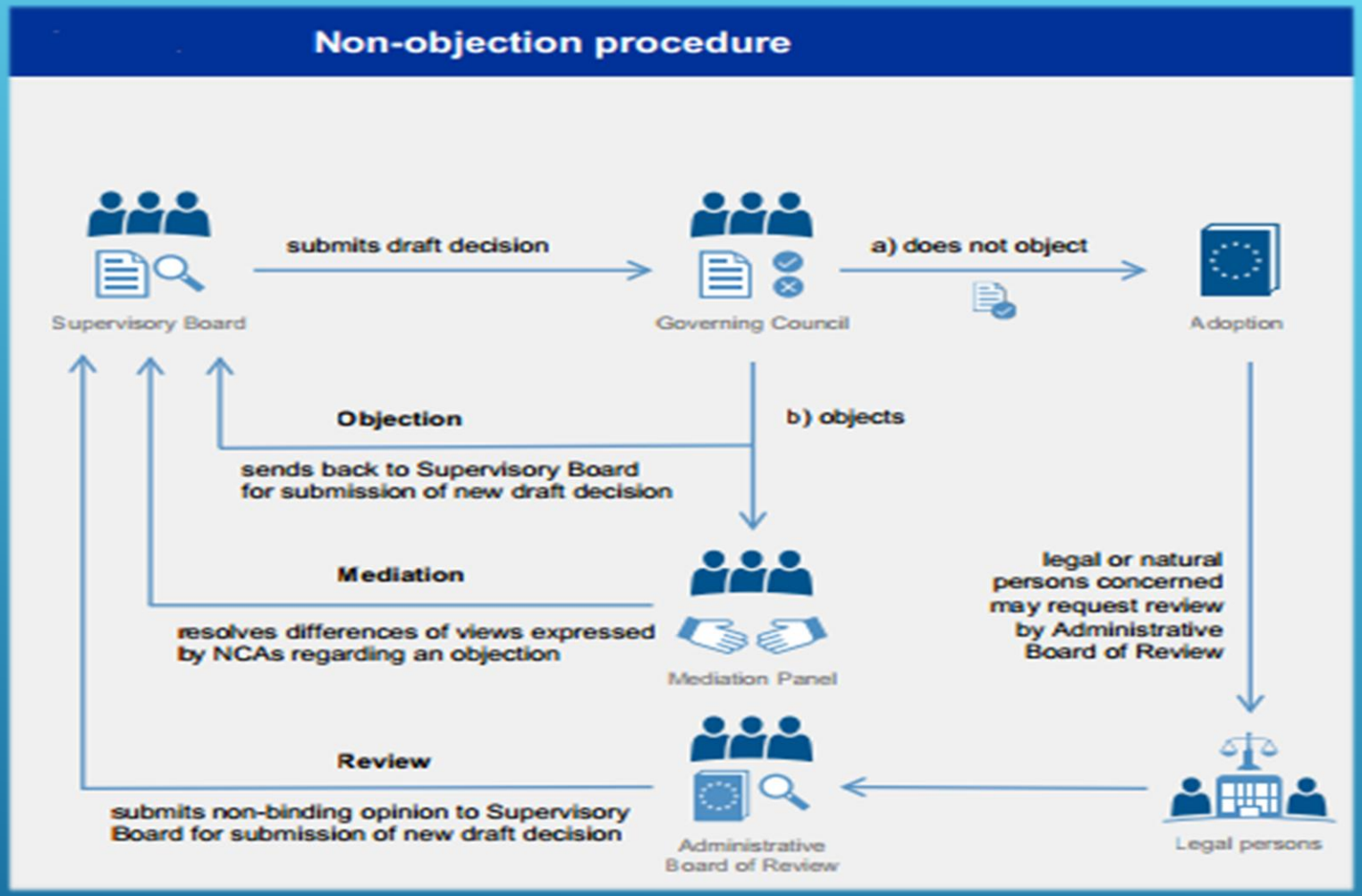
- ***Article 6 of the SSM Regulation lays down the general modalities for cooperation within the SSM between the ECB and NCAs***. The criteria laid down in this Regulation defining the scope of institutions that are less significant has been specified in the Framework Regulation
- ***The FR details how supervision will be carried out in practice, the legal framework and procedures of cooperation between the ECB and NCAs (including the methodology for the assessment of the significance of credit institutions). The FR was published by six months after the entry into force of the SSM Regulation i.e. 25 April 2014***
- It can be said that ***the FR fleshes out the general principles laid out in the ECB Regulation which underpin the SSM*** and thus covers the aspects expressly referred to in Article 6 (7) of the ECB Regulation

THE SSM AND FRAMEWORK REGULATIONS – AN OUTLINE

Decision-making within the SSM – the ***Supervisory Board***

- The planning and execution of the tasks conferred on the ECB shall be fully undertaken by an ***internal body composed of its Chair and Vice Chair, four representatives of the ECB and one representative of the national competent authority in each participating Member State*** ('Supervisory Board')
- ***The Supervisory Board is an essential body in the exercise of supervisory tasks by the ECB, tasks which until 3 November 2014, have always been in the hands of national competent authorities***. For this reason, the EU Council has been given the power to adopt an implementing decision to appoint the Chair and the Vice-Chair of the Supervisory Board
- The Supervisory Board is ***supported by a Steering Committee with a more limited composition***. ***The Steering Committee shall prepare the meetings of the Supervisory Board, perform its duties solely in the interest of the Union as a whole, and work in full transparency with the Supervisory Board***
- The decision-making process is based on a **"non-objection" procedure** (next slide). If the Governing Council does not object to a draft decision proposed by the Supervisory Board within a defined period of time that may not exceed ten working days, the decision is deemed adopted. **The Governing Council may adopt or object to draft decisions but cannot change them**
- The ECB has created a **Mediation Panel** to resolve differences of views expressed by the NCAs concerned regarding an objection by the Governing Council to a draft decision of the Supervisory Board (to date there have been no sittings of the said panel)

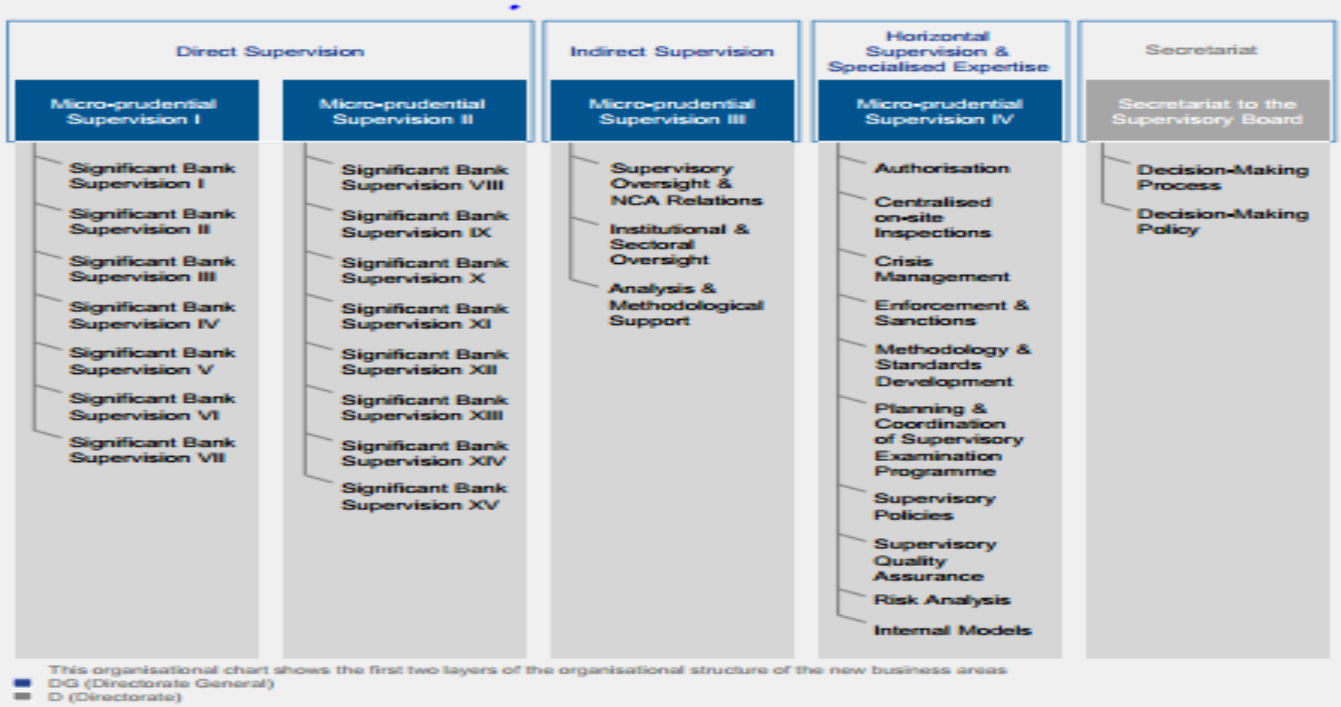
THE SSM AND FRAMEWORK REGULATIONS – AN OUTLINE



Source: ECB Guide to Banking Supervision November 2014

THE PRACTICAL IMPLICATIONS RESULTING FROM THE SSM WHICH IMPACT THE CONDUCT OF LOCAL BANKING SUPERVISION

Figure 3 Organisation of the SSM supervisory units in the ECB



Source: ECB Guide to Banking Supervision November 2014

THE PRACTICAL IMPLICATIONS RESULTING FROM THE SSM WHICH IMPACT THE CONDUCT OF LOCAL BANKING SUPERVISION

- The ECB has established four dedicated **Directorates General (DGs)** to perform the supervisory tasks conferred on the ECB in cooperation with NCAs:
  - **DGs Micro-Prudential Supervision I and II** are responsible for the direct day-to-day supervision of **significant institutions**;
  - **DG Micro-Prudential Supervision III** is responsible for the oversight of the supervision of **less significant institutions** performed by NCAs;
  - **DG Micro-Prudential Supervision IV performs horizontal and specialised tasks in respect of all credit institutions under the SSM's supervision** and provides specialised expertise on specific aspects of supervision, for example internal models and on-site inspections
- Additionally, a dedicated **Secretariat** supports the activities of the Supervisory Board by assisting in meeting preparations and related legal issues

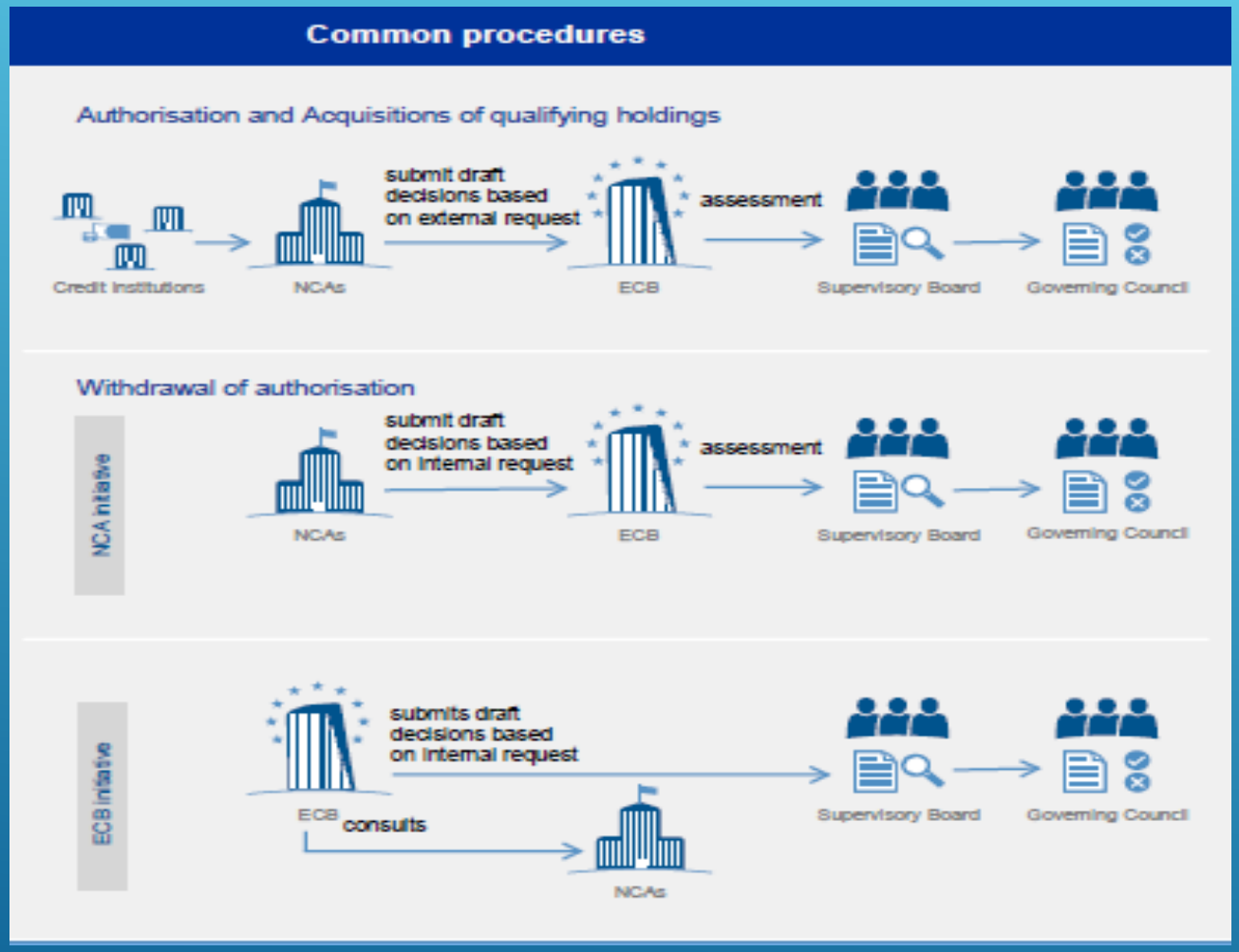
THE PRACTICAL IMPLICATIONS RESULTING FROM THE SSM WHICH IMPACT THE CONDUCT OF LOCAL BANKING SUPERVISION

- Ten **horizontal and specialised divisions** of **DG Micro-Prudential Supervision IV** support JSTs and NCAs in the conduct of supervision of both significant and less significant credit institutions
- These ten divisions are: **Risk Analysis, Supervisory Policies, Planning and Coordination of Supervisory Examination Programmes, Centralised On-site Inspections, Internal Models, Enforcement and Sanctions, Authorisations, Crisis Management, Supervisory Quality Assurance, and Methodology and Standards Development** – the BSU (7 themes), AU (1 theme) and EU (1 theme) are involved here
- The horizontal divisions **interact closely** with the JSTs in, for example, defining and implementing common methodologies and standards, offering support on methodological issues and helping them to refine their approach. The aim is to ensure consistency across the JSTs' supervisory approaches

THE PRACTICAL IMPLICATIONS RESULTING FROM THE SSM WHICH IMPACT THE CONDUCT OF LOCAL BANKING SUPERVISION

- The SSM Regulation has established a number of procedures, known as the "common procedures", which ultimately are decided on by the ECB, **regardless of the significance of the credit institution concerned i.e. applicable to both SIs and LSIs**
- These are the procedures for authorisations to take up the business of a credit institution, withdrawals of such authorisations and the assessment of acquisitions of qualifying holdings
- The SSM Framework Regulation sets out how the ECB and the NCAs are involved in these common procedures (next slide)

THE PRACTICAL IMPLICATIONS RESULTING FROM THE SSM WHICH IMPACT THE CONDUCT OF LOCAL BANKING SUPERVISION



Source: ECB Guide to Banking Supervision November 2014

THE PRACTICAL IMPLICATIONS RESULTING FROM THE SSM WHICH IMPACT THE CONDUCT OF LOCAL BANKING SUPERVISION

Supervisory processes

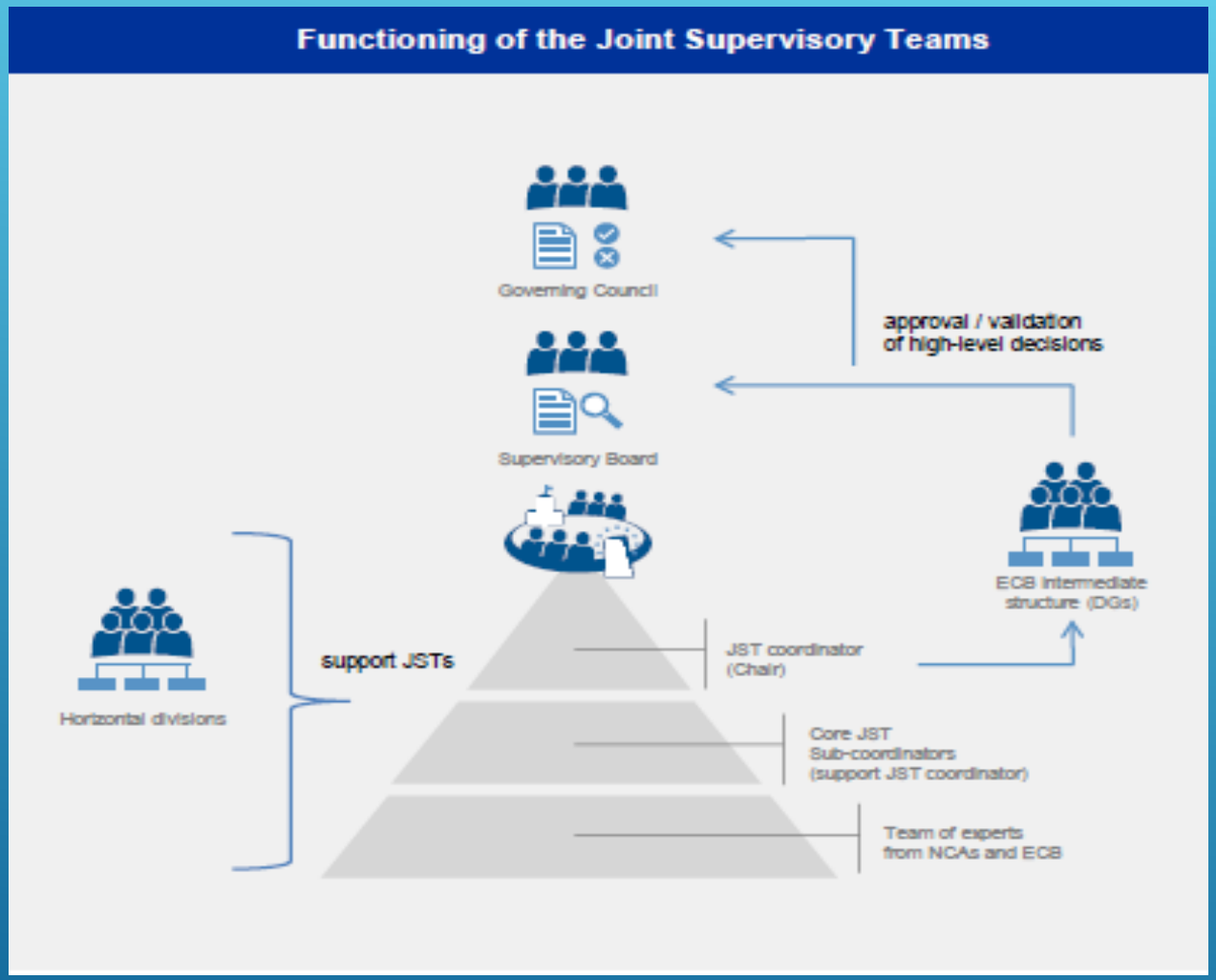
- The day-to-day supervision of significant institutions is conducted by Joint Supervisory Teams (JSTs). The JSTs comprise staff from both the ECB and the NCAs of the countries in which the credit institutions, banking subsidiaries or the significant cross-border branches of a given banking group are established. **A JST is established for each significant institution. Locally we are participating in 3 JSTs – BOV, HSBCM and DBM.** The size, overall composition and organisation of a JST can vary depending on the nature, complexity, scale, business model and risk profile of the supervised credit institution
- The ECB has also required that ***NCAs' supervisory teams involve staff from competent authorities of other participating Member States, making it possible to set up supervisory teams of geographical diversity with specific expertise and profile***. The exchange and secondment of staff should continue to contribute to the establishment of a common supervisory culture

THE PRACTICAL IMPLICATIONS RESULTING FROM THE SSM WHICH IMPACT THE CONDUCT OF LOCAL BANKING SUPERVISION

What are the key aspects of the SSM's supervisory model?

- The concept of ***Joint Supervisory Teams*** (JSTs) lies at the heart of the model. Thus JSTs will be:
  - ***established for every banking group/SI and comprise staff from the ECB and NCAs***
  - ***responsible for the day-to-day supervision of significant institutions and for the implementation of the annual SEP***
  - ***responsible for the implementation of the decisions of the Supervisory Board***
- While the size and composition of the JSTs vary according to the actual institution assessed there are common factors in the teams. In fact ***the JST Co-ordinator is always an ECB employee (not from the same country as the SI in question) while the Sub Co-ordinator would be an organisational manager from the NCA of the country of incorporation of the SI***. In the case of relatively large number of staff (presumably arising from the need to oversee large significant banks) a Core JST would be envisaged
- ***On-site inspections constitute a fundamental element of prudential supervision and naturally will form an integral part of the SSM's supervisory approach***

THE PRACTICAL IMPLICATIONS RESULTING FROM THE SSM WHICH IMPACT THE CONDUCT OF LOCAL BANKING SUPERVISION

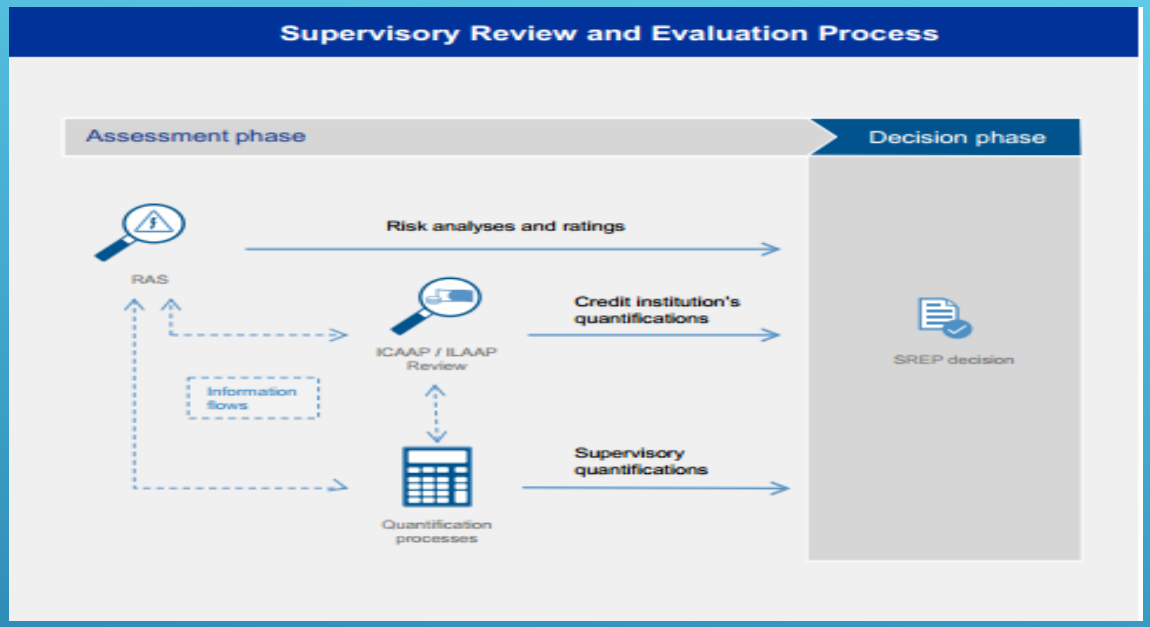


Source: ECB Guide to Banking Supervision November 2014

THE PRACTICAL IMPLICATIONS RESULTING FROM THE SSM WHICH IMPACT THE CONDUCT OF LOCAL BANKING SUPERVISION

- **On-site inspections on SIs** will be conducted in an independent yet coordinated manner:
  - **ECB horizontal function – COI** - plans the inspections in liaison with NCAs, coordinates the methodology and appoints Head of Mission for each inspection
  - The On-Site inspection team is independent from the JSTs during the inspection and draws up the Inspection Report and findings
  - JST members cannot ***lead*** the inspection but can participate in inspections
  - JSTs design corrective actions and recommendations and are responsible for follow-up
  - Summary of main findings will be regularly reported to Supervisory Board
  - NCAs assist the ECB and provide staff to the ECB's DG IV inspection team/personnel
  - ECB Quality Assurance function ensures (ex-post) the consistency of methodology used and outcomes

THE PRACTICAL IMPLICATIONS RESULTING FROM THE SSM WHICH IMPACT THE CONDUCT OF LOCAL BANKING SUPERVISION



Source: ECB Guide to Banking Supervision November 20140

The SSM SREP encompasses three main elements:

- a **risk assessment system** (RAS), which evaluates credit institutions' risk levels and controls;
- a comprehensive review of the institutions' **Internal Capital Adequacy Assessment Process** (ICAAP) and **Internal Liquidity Adequacy Assessment Process** (ILAAP);
- a **capital and liquidity quantification methodology**, which evaluates credit institutions' capital and liquidity needs given the results of the risk assessment

CONCLUSIONS

- The implementation of the SSM locally arguably had a (much) greater impact and will produce deeper and more significant effects overall on the banking supervisory oversight process conducted by the MFSA than had occurred say, in 2002 with the transfer of the responsibility of banking regulation and supervision from the CBM to the MFSA

- In 2002 the change could perhaps be described as a migration of a separate and possibly largely autonomous function from the core functions undertaken by a central bank as competent authority (the CBM) to another (the then MFSC) resulting in an single regulatory authority for financial services in Malta – the current MFSA

- However, ***the methodologies, practices, processes and procedures conducted by the MFSA Banking Supervision Unit (Banking Unit up to 2009 and BSU as from 2010) continued largely along the same lines as those conducted by the function when still at the CBM – except of course for those tasks which had to be amended, introduced or implemented as a result of relevant EU legislation subsequent to 2002. In a way this reflects that even in the European dimension, credit institutions, investment services and insurance business continue to be regulated by separate laws (albeit with some commonality in various legislation applicable to banks and investment firms***)

CONCLUSIONS

- The point is that the banking supervision function locally while benefitting from the interaction of other supervisory units within the MFSA over the last 13 years, had, to a certain extent, from a practical perspective still remained somewhat *distinct and unique* due to **the features of the applicable legislation**, **the idiosyncratic nature of the business undertaken by banks** and ultimately **the strong linkage of banks with the real economy and (ultimately) taxpayers**

- Accordingly, the implementation of the SSM has already effected the way the local banking supervisory function is undertaken and by extension has had a direct impact on the banks falling under the oversight of the Mechanism i.e. on both significant and less-significant institutions

- Thus, the MFSA through its integration within the SSM, has:

  - Initiated a process of internal reorganisation to cater for the new and substantially increased demands arising from the creation of the new supervisory function between the ECB and *inter alia* the MFSA. Just to mention some aspects here: appointment of representative to the Supervisory Board to attend the (on average) twice monthly meetings of the Board; restructuring of competencies within the BSU and some redesignation of existing functions and responsibilities; active (weekly) participation in ECB committees/work-groups in SSM composition mainly from BSU personnel but also for support functions such as legal, IT, human resources, statistics, internal audit etc.

CONCLUSIONS

- continued to augment its resources not only in the banking supervisory function but also in various other support functions within the MFSA - with possibly the area of IT being envisaged as the most likely recipient for such resource enhancement. To this effect the ECB as a banking supervisor has developed IT systems and infrastructure which are currently in use but is committed to further improved systems for use within the SSM to ensure both effective supervision and the consistent implementation of supervisory objectives outlined within the Framework Regulation and the SSM's Supervisory Manual

- to continue to cater for the fact that the resources available for the supervisory function have to sufficient to undertake all the processes, procedures, tasks and methodologies as laid down in the FR and Supervisory Manual. At the same time due allowance must however be made for the 'gap' in man-hours available at the local level through the continuous engagement within the SSM structures, training and the secondment of MFSA (primarily BSU) staff with the ECB and also through the exchange of staff with other NCAs as this will increasingly be an integral part of the SSM's drive to establish as far as possible a common supervisory culture

CONCLUSIONS

- continue to develop in a much more holistic and comprehensive manner, various competencies which to date may have arguably been underutilised within the local context e.g. communications strategy, internal audit, enforcement and the linkage between the legal and technical prudential functions

- ensure that notwithstanding the stand-alone nature of the MFSA's Authorisation Unit, the authorisation function for banks – in respect of the processes relating to the assessment of fitness and properness, licensing and "common procedure" - are fully co-ordinated with the MFSA's SB representative as ultimately it is this later forum which recommends through the "non-objection" procedure to the ECB's Governing Council i.e. the AU's banking authorisation function has through the advent of the SSM to implement methodologies and reporting lines separate from the rest of the licensable activities and functions relating from areas other than banking. **This is a result of the fact that the ultimate authorising authority for banks will not be vested in the MFSA's Supervisory Council but will rest with the ECB's Governing Council via the Supervisory Board**

- to consider to what extent, if at all, the governance arrangements relating to the SSM may need to be replicated within the Authority

CONCLUSIONS

- continue to develop **a more formalised approach to its supervisory tasks and responsibilities**. This will be reflected in the planning and coordination of the SEP, allocation of personnel for the purposes of co-ordination with JSTs. Moreover, it has been deemed beneficial organisationally to allocate Unit personnel to the specific oversight of significant banks and of less-significant banks i.e. personnel would only be responsible for banks within the same category and their work would not extend beyond their area of competence. This principle will be implemented more actively as resources available to the BSU continue to (hopefully) increase

- recognised that the various and varying aspects of the SSM's work require **dedicated or specialised resources**. This means that perhaps the BSU should ideally **move away from the current 'flexible approach'** to work assignments (which typical involve multi-tasking and less emphasis on specialisation). In fact, **a drive towards specialisation of personnel** is seen as being a '*sine qua non*' for the future especially when to date functions and tasks such as supervisory policy work, development of methodologies, participation in IT processes involving reporting frameworks, other policy-oriented work and (limited) quality assurance (which has started to be given much more importance have been carried out predominantly by BSU personnel engaged in hands-on on- and off-site supervisory oversight work

CONCLUSIONS

- develop further those operational functions which to date have (fortunately) not been priority areas e.g. crisis management, analysis of banks' recovery plans and early identification of potential problematic areas
- recognise that any experienced staff within the BSU recruited by the ECB will have to be replaced. While at this point in time it does not appear that this has had significant implications for the oversight function conducted by the BSU, the liaison with the ECB within the SSM in the coming months/years could create circumstances whereby any attrition could become more pronounced particularly in the case of those BSU staff working closely with the ECB on local significant institutions e.g. local personnel 'serving' in JSTs
- acknowledge that knowledge transfer, expertise and problem-solving capacities through the interaction of the BSU with SSM ECB personnel who are contributing to supervisory processes and procedures conducted on local significant banks, has introduced an material element of 'diversity in thinking' in local supervisory oversight. This has led to various changes in the processes and procedures which perhaps may have over the years become somewhat entrenched or ingrained in the local supervisory psyche
- has had to accept that 'national discretion' in decisions relating to banking supervision will for the most part become a thing of the past as the MFSA 's powers have largely devolved to the SSM. This fact should also be factored in by the local banks and condition their relationships and interface with their regulator

BANKING AND FINANCE LAW SEMINAR 2015

5 MARCH 2015

THANK YOU FOR YOUR ATTENTION