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ECB Seeks EU Banking M&A With New Supervisory Guide

The Guide is intended to provide fresh clarity on the ECB's approach to assessing proposed M&A transactions and enhance the transparency and predictability of supervisory actions.

Key Points:

Under the Guide, the ECB will:

- Not automatically penalise proposed M&A transactions by applying 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 the consolidation transaction
- Generally permit the use of badwill (i.e., the accounting gain generated by the acquisition of assets at a price lower than their fair value aka negative goodwill) to meet regulatory capital requirements
- Accept the temporary use of existing internal models to determine regulatory capital requirements, subject to credible model mapping and rollout plans to address the specific internal model issues created through the merger

The European Central Bank (ECB) has launched a public consultation on a new Guide detailing its supervisory approach to EU banking consolidation projects. The Guide is intended to help market participants determine the feasibility of banking consolidation transactions. The ECB invites comments by 1 October 2020.[1]

The ECB's supervisory priorities for 2020 include the profitability and sustainability of banks' business models,[2] which are important for increasing the resilience of banks and their capacity to service the economy. ECB Banking Supervision has stated several times that a certain degree of consolidation would be useful in addressing some of the structural challenges that banks are facing.[3]Banks' profitability remains under pressure from the economic environment, low interest rates, legacy issues, and competition from both other banks and non-banks. In addition, digitalisation poses significant challenges for banks, while simultaneously providing opportunities for efficiency gains and new business.

With respect to the Guide, the ECB considers that bank consolidation can play an important role in removing excess capacity, enhancing cost efficiency (improving return on equity), and promoting more focused and credible business models. Cross-border consolidation could also support greater risk diversification and contribute to financial market integration — an important objective within the banking union.

Background to the EU's banking sector

- Over 4400 credit institutions (banks) are in the Euro area[4] and participating member states of the SSM[5].

- Over 6000 banks are in the wider EU area[6] (nearly 9000 in 2009).

- Over half of the EU's banks are incorporated in only four jurisdictions: Germany, Poland, Austria and Italy, with Germany being home to over a quarter of all banks, and of those jurisdictions all but Poland are within the SSM.

- There has been a consistent, but falling, trend of consolidation following 2008 financial crisis, and in 2016 the value of transactions reached its lowest level since 2000.

- Compared with pre-2008, the post-crisis period is characterised by a predominant proportion of 'domestic' transactions. Of those domestic level transactions they are more often than not characterised as 'majority stake transactions', whereas at the cross-border level it is often minority stakes being taken[7].

According to the European Banking Federation the downward trend in the number of EU-28 banks, which started in 2009, continued in 2018, albeit at a slower pace, with the number falling to 6,088. This marked a decline of 2.6% compared to the previous year and a reduction of 2,437 (-29%), in total, meaning that one out of every four banks has disappeared since the financial crisis.

The FT reported that last year there were 77 deals between EU banks worth just over US$6 billion, the lowest number for over a decade and a fraction of the 218 deals worth US$123 billion completed on the eve of the financial crisis in 2006.

Why is the Guide important?

In the ECB's view, three supervisory factors can play a key role in determining the feasibility of a banking business combination:

- Post-merger Pillar 2 capital requirements (P2R) and Pillar 2 guidance (P2G)

- The prudential treatment of badwill

- The transitional arrangements for the use of internal models

Whilst the ECB has identified the supervisory factors it can provide further clarity on its Guide (further detailed in the sections below), an earlier EBA Staff Paper on *Potential Regulatory Obstacles to Cross-Broder Mergers and Acquisitions in the EU Banking Sector* identified that, as well as the general complexity of executing a bank merger or acquisition, the following factors may contribute obstacles to consolidation activity:

- Options and national discretions under the capital requirements framework may create an uneven playing field, increase regulatory complexity and compliance costs, and leave room for regulatory arbitrage.

- Host authorities/Member States may be reluctant to abandon policies of ring-fencing and pre-positioning of resources at the local level.

- The large exposures regime is an additional element of disruption to group-wide management of capital and liquidity resources, including the group's capability to support distressed group entities.

- Local market challenges may arise in the areas of methodologies for the capital adequacy assessments and in the determination of institution-specific additional own funds requirements. As now identified by the ECB, it was also highlighted that increased transparency in the definition and communication of Pillar 2 requirements (in a steady state and post-merger transition state) would positively extend to cross-border banking consolidation planning.

- The capital add-on resulting from the supervisory review and evaluation process (SREP) assessment is communicated by supervisors to banks as an overall requirement, without detailing the contribution of the different types of risks to its calibration; the absence of ex-ante knowledge of the capital amount required by the supervisor for each risk is a source of uncertainty for financial and business forecasting including the undertaking of M&A deals. The ECB's new guidance in this area should go some distance to addressing this challenge.

- The sometimes uneasy interaction between the national and EU frameworks (including political interaction) lends support to the argument for the importance of having a single EU merger assessment regime.

- There is a lack of an accomplished institutional framework for risk-sharing in deposit insurance and the financing of resolution.

- EU regulation deals only with the acquisition phase, which does not fully cover the assessment of the actual merger and the integration of the participating entities. This gap affects the transparency of the supervisory approval process and the predictability of its outcome, and potentially leaves room for national protectionist approaches. Unlike EU law, some national laws (e.g. in Belgium, Greece, Italy, and the Netherlands) do provide for a specific regime for the supervisory assessment of the merger. The advantage of such regimes is that they provide predictability to the acquirer.

The EBA paper considers that the EU needs to go further than the ECB Guide, and that an express regime should be introduced covering the supervisory expectations relating to both the steady state and the transitional phase of banking transactions. The information requirements for the merger assessment application and the applicable procedure and timeline should be made clear. The coordination of the authorities involved should be adequately covered. To achieve that, the EBA staff paper suggests that the EU expressly amend the Capital Requirements Directive[8] to introduce supervisory assessment and procedure requirements.

Which transactions does the Guide relate to?

The Guide applies to banking consolidation transactions. The Guide uses the term "consolidation" to mean any business combination of pre-existing independent legal entities that is relevant from the perspective of prudential supervision of banking institutions by the SSM (see endnote 3), excluding intra-group transactions. These business combinations include:

- Mergers between institutions

- The acquisition of a "controlling" interest[9] by one institution in another institution

Across the SSM Member States, a merger (e.g., a merger by absorption) generally means the parents of two banks coming together to head a bigger banking group, but could also include a situation in which two banks directly come together.

The Guide's approach is founded on the baseline case of a bank subject to the SSM seeking to acquire the control of another bank subject to the SSM. However, the ECB states that these principles remain valid, with the necessary adaptations, in all other cases, including when a non-bank or non-SSM bank is involved.

What is the role of the ECB in EU banking M&A?

The ECB has a formal role (and obligation to assess and approve/refuse a transaction) if the transaction either:

- Implies an acquisition of a qualifying holding in a bank incorporated in an SSM jurisdiction (meaning every acquisition of a direct or indirect participation in a bank that represents 10% or more of the shares and/or voting rights in that bank or crosses other relevant thresholds) or the creation of a new bank

- Involves *significant banks*[10] under the SSM and the law in their country gives the power to approve mergers to the national supervisor then the ECB will exercise these powers

In any case, the transaction will be reviewed as part of the ongoing supervision of the institutions involved. This means that the supervisors (at the national level and the ECB) will assess the viability and sustainability of the deal made by the banks to ensure that the resulting banking group will be able to continuously comply with all prudential requirements in the foreseeable future.

The ECB's prudential mandate is not to assess whether consolidation efforts are beneficial as such — this needs to be decided by market participants — but to make sure that the resulting business combination complies with prudential requirements and ensures effective and prudent risk management. Nor does the ECB have a bias against size and does not discourage banks from becoming bigger on principle, instead it relies on internationally agreed standards in place that require large and systemic banks to maintain additional capital buffers and/or loss-absorbing capacities.[11]

The supervisory expectations set out in the Guide will be embedded in the ECB's assessment of the applicable criteria for the approval of the proposed transaction. The ECB notes that past experience shows that there is no "one size fits all" approach when it comes to banking sector consolidation. Consequently, a case-by-case approach based on proportionality in the application of the Guide's principles should be expected.

But, let's consider the here and now.

What are the key aspects of the Guide?

Pillar 2 capital requirements (P2R) and Pillar 2 guidance (P2G)

The supervisory approach for the calculation of a merger's ex-post P2R and P2G will be guided by the following two key principles:

- A thorough assessment and mitigation of the main weaknesses of the combined entity and of the execution risk in the business plan

- An appropriate level of Pillar 2 capital,[12] aligned with the risk profile of the combined entity

In assessing the appropriate ex-post level of capital, consideration will be given to the fact that, in general, in a consolidation transaction, a large part of the costs deriving from the business combination are booked upfront, while the potential benefits of such a transaction are accrued at a later stage. It should then be possible to take into account integration plans with credible trajectories for the level of capital in a reasonable time horizon. Therefore, the starting point for determining the P2R and P2G levels of the combined entity will be the weighted average of the P2R and P2G levels applicable to the two entities prior to the consolidation transaction.

This starting point can be adjusted upwards or downwards based on a case-by-case assessment of the combination's risk profile and resiliency of business model.

The ECB expects to be able to clarify these requirements during the application for approval of the transaction phase, so market participants can expect stability for the combined business (the ECB says at least for the year post-combination).

While allowing for sufficient implementation time, the general principle is for a return to standard supervisory activities — in particular, the standard SREP process — in a timely manner.

For cases in which the entities involved were already under ECB Banking Supervision, this means, for example, that the first post-merger regular SREP assessment will not result in an increased own funds requirement for the bank, unless enhanced monitoring ascertains that additional risks are insufficiently covered (e.g., if there is evidence that the implementation progress is falling short of the agreed milestones and yardsticks). Qualitative and quantitative requirements other than P2R and P2G, such as liquidity, will also be reviewed and adjusted if needed.

Badwill

A proposed combination may result in the generation of goodwill[13] or badwill.[14] In the current climate for banking consolidation projects, badwill will likely be generated.

In principle, ECB Banking Supervision recognises duly verified accounting badwill from a prudential perspective and will examine its actual and potential use, expecting it to be used to increase the sustainability of the business model of the combined entity, for example by increasing the provisioning for non-performing loans, to cover transaction or integration costs, or other investments, and generally strengthening the post-merger own funds of the combined entity.

Internal models

As a general rule, ECB Banking Supervision 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.

In the event of a business combination, the formation of new legal entities or the transfer of exposures to existing legal entities incorporating other entities may raise questions about the continued use of internal models, as newly authorised legal entities cannot have approval to use internal models from the start, and existing legal entities may not have approval to use their internal models for newly acquired exposures.

In such cases, subject to a clear model mapping and a credible internal models rollout plan to address the specific internal model issues created through the merger, as well as other conditions where appropriate, ECB Banking Supervision acknowledges that there will be a limited period of time in which banks resulting from the business combination might continue to use the internal models that were in place before the merger. The aim is to avoid an unnecessary supervisory burden linked to undue volatility in risk-weighted assets and reduction in risk sensitivity if legal entities temporarily revert to the standardised approach.

Efficiency in the use of internal models is key for banks when it comes to loan pricing, the ability to attract customers, and the profitability of a business line across markets with similar characteristics. As the application of a variety of models in different entities within the same group can have significant effects on loan pricing, the ability to attract customers, and, ultimately, the profitability of a business line, confirmation of the ECB's position should allow market participants s more time and greater transparency with which to assess the feasibility of a proposed transaction.

How to execute a transaction in line with the Guide

Practical considerations for market participants:

- Identify early on whether the proposed transaction will require the prior approval of the national regulator and/or ECB.
- If ECB approval will be required, liaise as soon as possible with ECB Banking Supervision to obtain preliminary feedback on the project and Pillar 2 requirements.
- If a merger or business combination is proposed, provide a robust, credible, and informative firm-wide or group-wide integration plan as part of the early communication phase so that ECB Banking Supervision can carry out an accurate and thorough preliminary assessment. The ECB will monitor implementation of the plan on an ongoing basis.
- In the context of an acquisition or if a merger or business combination is proposed, when appropriate, focus on producing a credible and comprehensive group-wide business plan with plausible assumptions and valuations adjusted by an appropriate margin of conservatism.
- Identify the use of internal models for the purpose of calculating capital requirements, and if advantageous, begin to consider model mapping and rollout plans for continued use of the internal models by the combined business.

Other important considerations

Market participants should be aware of the following:

- For a target in the SSM, the ECB will play a central role in approving the deal, the terms of operation following the buyout, and plans for consolidation or buy-and-build strategies. Regulators generally prefer a bank's owner to be long-term, open to injecting additional cash, and fully accountable in a worst-case scenario. The ECB will make its assessment against five key criteria:
  - Reputation of the proposed acquirer
  - Reputation and experience of the proposed new managers
  - Financial soundness of the acquirer

  - Impact on the bank(s)
  - Risk of links to money laundering or terrorist financing

- Post-closing funding of the bank must be considered; securing a favourable rating for the bank is a key milestone.
- Securing membership of the bank in a deposit protection system can be crucial in keeping funding affordable.
- Acquirers should seek protection against burdensome conditions imposed by regulators. The obligation to complete the transaction should be made subject to no burdensome condition being imposed.
- Indemnities may be sought against significant skeletons, such as mis-selling of financial products, or FX and LIBOR manipulation.
- Acquirers must also factor in additional time to the transaction timelines, as satisfying regulatory demands can take nine months to a year.
- Local regulators require satisfaction of “fit and proper” tests and may ask acquirers to reveal business plans or provide detailed personal and sensitive information about a firm’s representatives and officers.
- Prospective buyers will need to consider management incentive plans in light of remuneration laws for bank officers and representatives, and carry and management fees in light of regulatory requirements.

In some jurisdictions that have a more fragmented banking market, such as Germany (in particular as a result of its three sector banking model of private banks, savings banks, and co-operative banks), consolidation has been discussed as a priority in recent years. Meanwhile, consolidation in the savings bank sector and the co-operative bank sector is being driven forward, partly due to pressure applied by dominant players in the sector or by the regulators. Consolidation is also being driven forward by private equity investors that are applying a buy-and-build (or similar) model. Recent experience in the market shows that transactions can be executed smoothly, but that the interplay between the ECB and national regulators requires careful navigation.

Latham & Watkins has a multi-disciplinary and multi-jurisdictional financial institutions group that has advised on the transactional and regulatory aspects of multiple recent UK, Germany, Spain, and wider-EU bank consolidation projects before national authorities and the ECB, including advising acquirers, targets, shareholders, bank supervisory boards, and national deposit protections schemes.

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Endnotes

[1] Respond here: https://www.bankingsupervision.europa.eu/legalframework/publiccons/html/consolidation.en.html.

[2] https://www.bankingsupervision.europa.eu/banking/priorities/html/ssm.supervisory_priorities2020~b67449d936.en.html#toc8.

[3] https://www.bankingsupervision.europa.eu/press/blog/2020/html/ssm.blog200701~09226934fb.en.html.

[4] As at May 2020 (source: https://www.ecb.europa.eu/stats/ecb_statistics/escb/html/table.en.html?id=JDF_MFI_MFI_LIST).

[5] The Single Supervisory Mechanism ("SSM") refers to the system of banking supervision in Europe. It comprises the ECB and the national supervisory authorities of the participating member states (all those member states in the Euro area and those who have entered into a 'close cooperation' agreement with the ECB). The ECB directly supervises the 115 'significant' banks of the participating member states and it is also responsible for approving acquisitions and disposals of qualifying holdings in banks in member states of the SSM.

[6] Source: https://www.ebf.eu/facts-and-figures/structure-and-economic-contribution-of-the-banking-sector/.

[7] March 2020 (Source: https://op.europa.eu/en/publication-detail/-/publication/17d52f15-6289-11ea-b735-01aa75ed71a1/language-en/format-PDF/source-120564925).

[8] EU Directive 2019/878 (Capital Requirements Directive V).

[9] The acquisition of a *qualifying holding* as defined in the Capital Requirements Regulation.

[10] Source: https://www.bankingsupervision.europa.eu/banking/list/criteria/html/index.en.html

[11] Source: https://www.bankingsupervision.europa.eu/about/ssmexplained/html/bank_mergers_acquisitions.en.html.

[12] 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). P2Rs are binding and breaches can have direct legal consequences for banks. The P2R is determined via the Supervisory Review and Evaluation Process (SREP). 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.

[13] In accordance with Appendix A of IFRS 3: Business Combinations, goodwill is defined as an asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognised.

[14] Badwill, also known as negative goodwill, occurs when a company purchases an asset at less than its net fair market value. Typically, badwill occurs when one company purchases another at a price that is below its book value.