SSM vs. special public supervision on covered bond issuers

18th Central European Covered Bond Conference

The SSM in the global market context (I/II)

- Current situation is characterized by:
  - Excessive liquidity for banks practically at zero cost accompanied by …
  - …subdued economic growth mostly due to …
  - …high unemployment in the periphery and …
  - …close to zero inflation rate in combination leading to …
  - …richening of practically all fixed income products.

- Cheap funding is not translated into higher loan production due to scarcity or looming scarcity of equity as well as low demand for loans – in particular from SMEs.

- With around EUR 30bn in deposited overnight at the ECB yielding -20bp the overall situation comes close to a classical liquidity trap. Ideally, a liquidity trap is also associated with the fear for higher rates resulting in real cash holdings rather than a constant run on liquid FI assets.

- Numerous economic text books – taking reference to J.M. Keynes - mention a higher inclination of lawmakers, regulators or central banks to actively intervene in capital markets.

The SSM in the global market context (II/II)

Regulatory/Central Bank Measures and how they interact

	what it is about	pro	con	positive correlation with goals of	negative correlation with goals of
TLTRO/Purchase programs	restore the transmission mechanism of monetary policy; foster inclination to provide loans to economy	cheaper funding	mispricing of risk	Negative Deposit Rate	AQR/minimum capital requirements
min. capital requirements	safeguard sounder capitalization in particular for systemic important banks	higher capital buffer	pressure on revenues	AQR	TLTRO/Purchase programs; negative deposit rate
negative deposit rate	foster inclination to provide loans to economy	theoretically suitable tool…	...which fails to meet reality	TLTRO/Purchase Programs	purchase programs
LCR	improve soundness of banks due to larger liquidity portfolios	regulating liqudity status	pressure on revenues; political rather than economical definition of liquid asset		Leverage Ratio; TLTRO/purchase programs; negative deposit rate
Leverage Ratio	cap on ratio between total assets and equity	regulating leverage	non-risk adjusted measure punishes banks with low-risk-assets		LCR
NSFR	safeguard better match of maturity profiles of assets and liablities	lower mismatch	maturity transformation is one of the most important rights for banks to exist	LCR	TLTRO/purchase programs
AQR	foundation to start singly supervisory mechanism	supervisor gets initial overview		min. capital requirement/LCR/NSFR; SSM	TLTRO/purchase programs
SSM	alignment of banking supervision on a European level	improvement of banking supervision in particular for banks writing pan-European business		AQR	

Source: UniCredit Research

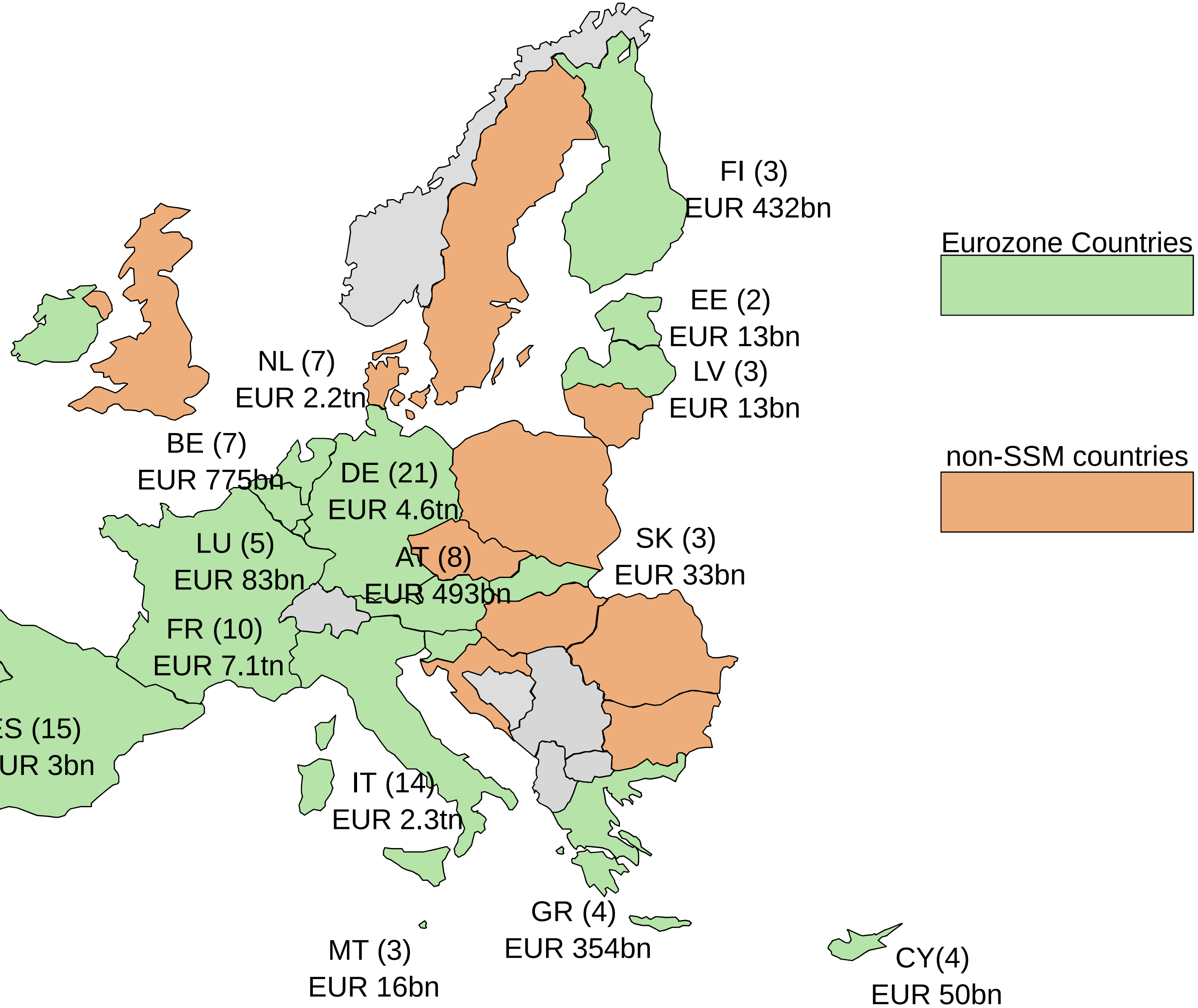
The Single Supervisory Mechanism

- The Single Supervisory Mechanism (SSM) is integral part of the European Banking Union. It is accompanied by the Single Resolution Mechanism (SRM), which will establish uniform rules and procedures for the resolution of failing banks.
- The SSM will create a new system of **banking supervision at t**he ECB and the national competent authorities of participating EU countries.
- Among these EU countries are those whose currency is the euro and those whose currency is not the euro but who have decided to enter into close cooperation with the Single Supervisory Mechanism.
- The legal basis for the SSM was laid on 29 October 2013. This regulation entered into force on the fifth day following the publication, i.e. on 3 November 2013. The ECB will assume its new supervisory tasks on 4 November 2014.
- The main aim in of the Banking Union is that the implementation of a European single supervision mechanism in conjunction with a single resolution mechanism will make a key contribution towards restoring financial stability in the euro area.

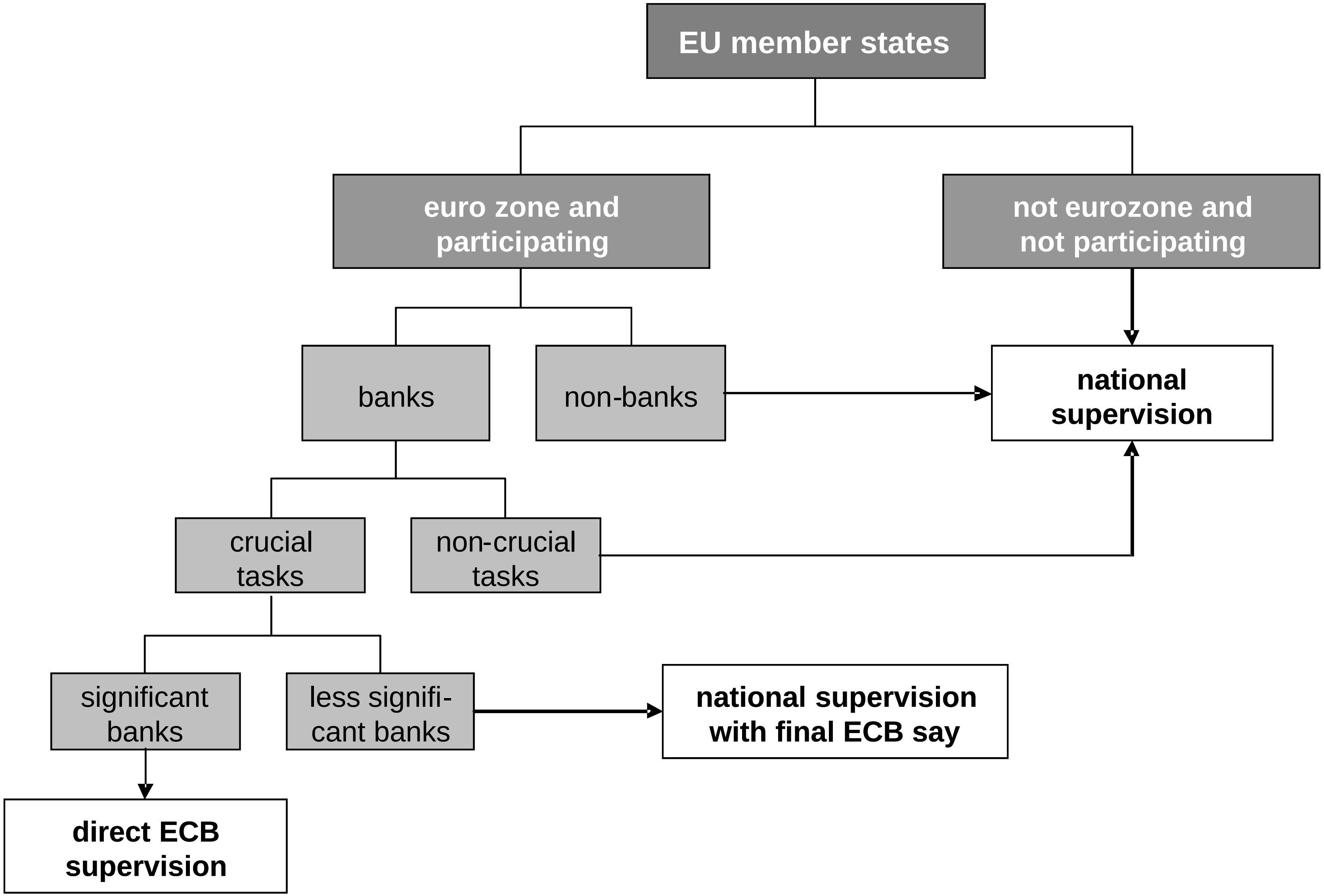
Scope of the SSM

- The SSM confers supervisory powers to the ECB in full for banks located in the euro area exceeding particular thresholds. However, banks referred to in Article 2 (5) of the Capital Requirements Directive (CRD IV) are excluded, for example central banks of the member states and several other named banks like the KfW in Germany. In any case:
  - The SSM will only include member states within the eurozone (obligatory) and member states outside the eurozone that decide to join the SSM (voluntary), together known as the "participating member states" (see next page).
  - The SSM endows the ECB with specific supervisory powers. Any supervisory functions not transferred to the ECB will be carried out by national supervisors. These tasks can be seen as not being crucial for the stability of the financial sector.

SSM Countries



Who's got the power?



And what "The Power" means in detail

- The ECB either conducts itself or delegates the following tasks:
  - Ensure **compliance with EU law**, including national law that implements EU legislation, that imposes requirements on banks with respect to own funds, securitization, large exposure limits, liquidity, leverage, and reporting and public disclosure of information on such matters. This constitutes the core of bank supervision.
  - **Authorizing banks** and withdrawing authorization of banks.
  - If a bank is established in a participating member state and wishes to **establish a branch** or provide cross-border services in a non-participating member state, the ECB has to **carry out the tasks the competent authority of the home member state should have under the relevant EU law.**
  - Supervise the **governance arrangements** in banks.
  - Supervision on a **consolidated basis**, including financial holding companies and mixed financial holding companies, and to participate in supervision on a consolidated basis.
  - Assessing **mergers, acquisitions and disposals** of banks. National authorities will prepare the assessment of acquisitions, but the ECB makes the final decisions.
  - Carry out supervisory reviews, including stress tests and supervisory tasks in relation to **recovery plans, and early intervention.**
  - Participation in supplementary supervision of a **financial conglomerate** in relation to the bank included in it.

4 November 2015: ECB takes over supervision

- Having a **Single Supervisory Mechanism (SSM)** in place can hardly be seen negative. Internationally operating banks should be supervised also by a supranational entity.

- Covered Bond wise the topic is tricky:

  - UCITS 52(4): Member States may raise the 5 % limit […] to a maximum of 25 % where bonds are issued by a credit institution […] and is subject by law to **special public supervision** designed to protect bond-holders.

  - In the epic response to the EU Commission titled " EBA Report on EU Covered Bond Frameworks and Capital Treatment" EBA takes reference to Covered Bond special public supervision

EBA's discussion

- EBA took a closer look at European supervisory practices in four different contexts:
  - Covered Bond oversight prior to issuance
  - Ongoing supervision
    - EBA considers aspects like on-site inspections, supervision of changes to the program, role of the supervisor in appointing various figures involved, asset eligibility criteria, coverage calculations etc.
  - Supervision post issuer's default
    - EBA states the particular relevance of supervision post insolvency ("designed to protect bondholders")
  - Operational aspects
    - Covered Bond-specific units, independent cash-flow calculations, stress scenarios …

Covered Bond oversight prior to issuance

- EBA recognizes significant national specifics between:
  - One-off licensing for becoming a "covered bond bank":
    - France, Spain, Ireland, Italy
  - One-off covered bond specific licensing:
    - Austria, Germany, Denmark, Finland, Netherlands, Norway, Sweden
  - Authorization prior to each program:
    - Germany, Netherlands, UK
  - Ex-ante notification of each program:
    - Finland, France
  - Notification of issuance:
    - Portugal (ex ante), UK (ex ante), Netherlands (ex post)

Ongoing supervision

- Ongoing supervision is probably the aspect that draws the most attention as well as it is the most complex topic in the context of special public supervision:

- One of the most interesting aspects in ongoing supervision is the role between trustee, cover pool monitor and supervisory authority

  - Implementation of regular on-site inspections;
  - Reporting requirements;
  - Implementation of supervisory guidelines specific to covered bond issuance business;
  - Supervision of changes in the features of existing covered bond programs;
  - Role of the supervisor in the appointment of the various figures involved in the monitoring/management of the CB program;
  - Supervision of asset eligibility and asset valuation criteria;
  - Supervision of coverage calculations;
  - Supervisory prompt corrective action practices.

Supervision post issuer's default

- This might appear a bit strange to some readers, however this is where the UCITS wording "designed to protect bondholders" really becomes reality.

  - The first and most prominent duty of the supervisor in or shortly before an issuer default is the appointment of the cover pool administrator … normally

  - However, this aspect is quite broadly designed:
    - Germany: supervisor proposes to court the administrator, can propose to court to dismiss the administrator, can undertake ad hoc audits of the cover pool, etc.
    - France: supervisor appoints the special administrator and is entitled to impose random audits
    - Finland: supervisor appoints administrator and supervises the program
    - Ireland: supervisor "may request" the national treasury to identify a suitably qualified person or appoint the NTMA if such a suitably qualified person cannot be identified
    - …
    - Spain: Insolvency court will appoint the insolvency administrator amongst those suggested by the deposit guarantee fund (the management committee of the deposit guarantee fund is currently composed of 12 members, six of them designated by the Bank of Spain).

Operational aspects

- The organization of the supervisor in relation to CB supervision, in particular whether the supervision of CB is carried out by CB-specific units and whether the supervision is organized in issuer-specific teams;
- The practice of developing independent cash flow sensitivity/stress test models for the supervision of covered bond programs
- The practice of providing supervision staff members covered bond business-specific training.

EBA final recommendations on supervision

- #1: The legal/regulatory covered bond framework should provide sufficiently detailed description of what the duties and powers of the competent authority are on the covered bond program, as well as its administration, in a scenario of issuer's default

- #2: Requirements relating to the role of the special public supervision should be considered for inclusion among the qualifying criteria determining the preferential treatment enshrined in Art. 129 of the CRR

- #3: The legal/regulatory covered bond framework should provide a clear and sufficiently detailed illustration of the duties and powers of the competent authority regarding the ongoing supervision of the applicable activities/regulatory requirements of covered bond issuers.

- #4: The legal/regulatory covered bond framework should provide sufficiently detailed description of what the duties and powers of the competent authority are on the covered bond program, as well as its administration, in a scenario of issuer's default.

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