ECB-SSM releases final supervisory "Guides" on banking license applications

May 2018

How does this change the license process for traditional and FinTech firms and what clarifications are provided on the CRR/CRD IV Framework ?

Quick Take – Key impacts from ECB-SSM's new license requirements

The ECB-SSM's two new supervisory "Guides" harmonise the rules but also deepen the level of detail that applicant firms will need to submit when applying for a new or varying an existing license to act as a credit institution. Moreover, the standalone guide on FinTech credit institutions creates additional obligations for these types of firms. The Guides also provide useful guidance on the interpretation of certain terms in the CRR/CRD IV Framework which will be of interest to all new and existing Banking Union Supervised Institutions. Given the heightened volume of license applications, due to BREXIT and otherwise, and the long lead timelines, market participants ought to assess and take action now.

March 23, 2018 marked the beginning of spring. For EU-27 as well as the Eurozone-19 and its Banking Union, it marked the start of the supervisory and regulatory publications "season" ahead of the summer break. The European Central Bank (ECB), as the lead within the Single Supervisory Mechanism (SSM) pillar of the Banking Union, published the final versions of its two supervisory "Guides" on license applications. These apply to applicants requiring a license for traditional banking sector activity as well as those engaged in FinTech banking sector activity. The final supervisory Guides follow on from the draft versions that were previously put through a short consultation period that ran from September to November 2017. The final versions make only minor additions to what were in the draft versions. Details of changes and context why are set out in a Feedback Statement.[1]

Whereas national authorities[2] in the SSM are the "entry point" to the authorization and license process, the ECB-SSM is the ultimate decision maker on all banking license applications in the Eurozone-19 and its Banking Union, as well as a host of specific supervisory powers granted under national law which are not explicitly mentioned in EU law.[3] This Client Alert assesses in two parts the practical impacts of these final Guides and how they apply to traditional and FinTech credit institutions. Given the heightened volume of license applications, due to BREXIT and otherwise, and the long lead timelines, market participants ought to assess and take action now.

This is also especially the case, as the final Guides, like the draft versions, refer to and thus require compliance with the detailed obligations contained in Regulatory Technical Standards on information requirements for the authorization of credit institutions[4] (the EBA License

[1] See: https://www.bankingsupervision.europa.eu/legalframework/publiccons/pdf/licensing_and_fintech/ssm.feedbackstatement.en.pdf Surprisingly, the ECB only received 16 responses to its consultation, only two of which were credit institutions and the rest coming from market and banking associations from the Eurozone and remainder of EU.

[2] See the following, including a link to national authorities' application forms: https://www.bankingsupervision.europa.eu/banking/tasks/authorisation/html/index.en.html

[3] These powers were communicated to various national supervisory authorities and other competent authorities in a public letter (SSM/2017/0140), dated 31 March 2017, available here: https://www.bankingsupervision.europa.eu/banking/letterstobanks/shared/pdf/2017/Letter_to_SI_Entry_point_information_letter.pdf?abdf436e51b6ba34d4c53334f0197612 (the SSM Hierarchy Letter)

[4] These rules are currently housed on the EBA website pending their final adoption by the European Commission: https://www.eba.europa.eu/-/eba-publishes-final-standards-specifying-information-requirements-for-the-authorisation-of-credit-institutions

RTS).[5] Those rules, as set by the European Banking Authority (EBA), surpass what may be in authorization forms and processes published by national authorities,[6] and a number of market participants may have been previously unaware of what those rules require in terms of detail and preparation or that certain items are required to be submitted to the ECB-SSM directly.[7] They also in parts may differ to what is required[8] in application forms for other types of regulated entities, such as MiFID investment firms, which may often be the entity chosen to house non-deposit taking "investment banking" business that operates in parallel to an ECB-SSM supervised deposit taking credit institution authorized pursuant to the CRR/CRD IV Framework.

As with other SSM relevant Guides, these two newest publications read very much like—and thus should probably be interpreted as—rulebooks.[9] These Guides harmonize supervisory practices, compile specific supervisory expectations on compliance by firms but also expand the scope of the EU's Single Rulebook within the Banking Union, by introducing the concept of a FinTech credit institution (FCI) as well as by expecting those applying to become Banking Union Supervised Institutions (BUSIs) in complying with the Guides also observe the standards in the EBA License RTS. They also provide clarifications on certain terms used in EU-wide prudential capital regulation in the CRR/CRD IV Framework.

The following two ECB-SSM Guides are complementary to one another, especially for those aspiring to become FCIs or for traditional credit institution undertaking FinTech activity:

- "Guide to assessments of license applications: License applications in general"[10] (the General License Application Guide or GLAG) discussed in Part I herein; and
- "Guide to assessments of fintech credit institution license applications"[11] (the FinTech License Application Guide or FLAG) discussed in Part II herein.

Each of these supervisory "Guides" contain common concepts and approaches that are relevant to credit institutions with additional requirements introduced by the FLAG in respect of FCI applicants. Both Guides are designed to be flexible and capable of amendment so as to remain practical and relevant in promoting awareness and transparency of the assessment criteria and processes of the establishment of a credit institution within the SSM. In particular, the final versions, like the drafts, earmark that the ECB-SSM will develop further standards on assessment of regulatory capital as well as the regulated business plans a.k.a. "program of operations". They also tie-in with other SSM workstreams. Notably, these licencing Guides should also be read in conjunction with the ECB-SSM Guide on assessing the fitness and propriety of natural persons in relation to certain functions requiring supervisory approval (the F&P Guide)[12] or the ECM-SSM Guide on-site inspections and internal model investigations (the OSIIM Guide).[13]

All of these supervisory Guides and expectations will change how existing and new BUSIs engage with national and ECB components of the SSM. For those that will qualify as FCIs, the Guides should also be read in conjunction with the EBA's policy on FinTech. The ECB-SSM's move to establish supervisory expectations in terms of FCI's license applications, is a welcome move to establish greater harmonization and certainty in an area of rapid transformation.

Harmonization of the licencing process using a jurisdiction agnostic approach

The ECB-SSM's aim of achieving greater harmonization of supervisory principles and practices is a general overarching priority. This now also specifically applies to licencing applications by introducing common standards and procedures that, as they are "jurisdiction agnostic," harmonize yet also interoperate with existing national standards and processes. All of this aims to ensure the SSM's application of the EU's Single Rulebook for financial services across the Banking Union is truly more single.

---

5 Para. 2.3 of the GLAG clarifies that: "The ECB applies all relevant EU acts adopted by the European Commission on the basis of drafts developed by the EBA, in particular the regulatory technical standards (RTS) on the information applicants need to provide to competent authorities when applying for authorization as credit institutions, and the implementing technical standards (ITS) related to the templates for providing such information."

6 This list is set out, at the time of writing here: https://www.bankingsupervision.europa.eu/banking/tasks/authorisation/html/list.en.html

7 As per the clarifications set out in the SSM Hierarchy Letter.

8 As set out, inter alia in Commission Delegated Regulation 2017/1943: which is available here: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017R1943&from=EN

9 This is despite the heading of the Guides stating: "The policies, practices and processes set out here may have to be adapted over time. This Guide does not have a legally binding nature and consists of a practical tool to support applicants and all entities involved in the process of authorization to ensure a smooth and effective procedure and assessment. The Guide will be updated regularly to reflect new developments and experience gained in practice." as the Guides refer to legislative texts and supervisory expectations that are binding or otherwise very persuasive in their application. Moreover, the start of para. 2.4 states: "The supervisors need to apply the regulatory requirements when assessing license applications. To ensure that they do so consistently, the interpretation of those requirements needs to be clarified and common supervisory practices and processes need to be developed."

10 https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.201803_guide_assessment_credit_inst_licensing_appl.en.pdf?b270f2a7b408f41c68a2935007f610b5

11 https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.201803_guide_assessment_fintech_credit_inst_licensing.en.pdf?1c99fa2126f6ef80eb61a276bab94379

12 See our recent Background Briefing on this available from our Eurozone Hub.

13 More on this from our Eurozone Hub.

Having a uniform Single Rulebook, based on a single supervisory culture contributes to a greater "level playing field" for BUSIs. Extending this approach to regulatory license applications aims to reduce the risk that applicants circumvent banking sector regulation and supervision. It also helps SSM but also other EU and national-level supervisory staff in greater comparison of how applicants rank in terms of their peers in one jurisdiction but also across multiple EU Member States.

Relation of the GLAG, FLAG and FCIs with EU requirements

Whilst the introduction of the FCI concept is of course welcome, it is important to note, that as a concept it does not exist in other EU, Eurozone and indeed global regulatory and legislative instruments. An FCI will not have its application or on¬going supervision regulated and supervised as a light-touch version of a credit-institution. This is the case even where existing rules allow for a proportionate approach to supervision in respect of smaller and less-complex business models.

In terms of process, the GLAG and the FLAG, supplement national level instruments. A credit institution license application process may also mean the involvement of other national authorities in the European System of Financial Supervision or indeed separate applications for licenses. The processes of the GLAG and the FLAG do not replace those other processes.

Greater clarity on key terms in the CRR/CRD IV Framework

That being said, these ECB-SSM level supervisory Guides are limited to the Banking Union. They do not aim to replace or displace rules and supervisory approaches outside the scope of the SSM's scope and mandate. The GLAG does specifically, however, provide useful guidance, without prejudice to national law, on terms not otherwise defined in the CRR/CRD IV Framework.

This is particularly relevant where national transposition of the CRR/CRD IV Framework, as an EU regime, into the respective Member States has led to inconsistencies amongst national regimes. Some of these inconsistencies are due to national options and discretions but may also be because of incorrect interpretation and application by national authorities or their differing supervisory approaches. The GLAG's clarification on these inconsistencies aims to harmonize understanding in respect of some key terms in the CRR/CRD IV Framework. These include:

- Clarification that "deposits and other repayable funds" include, for supervisory purposes, long-term savings accounts, current accounts, immediately repayable savings accounts, funds in investment accounts, or in other forms that are to be repaid. Reference is also made to a 1999 Court of Justice of the European Union judgment[14] where it was determined that "... **"other repayable funds" refers not only to financial instruments with the intrinsic characteristic of repayability, but also to those which, although not having that characteristic, are the subject of a contractual agreement to repay the funds paid."** This could bring a much larger scope of activity into the ECB-SSM's supervisory mandate. "Deposits" are clarified as those that are covered in the Deposit Guarantee Scheme Directive[15] and confirms that funds received in the course of payment services activity or e-money activity is not subject to the CRR/CRD IV Framework but the relevant PSD2 and E-Money frameworks;
- Clarification that "public," for prudential regulatory and supervisory purposes, implies "...an element of protection for natural or legal persons entrusting funds to unsupervised entities whose financial soundness is not established." The GLAG thus, perhaps rather imprecisely, aims to delineate between what is the "public" and those that are have a (personal) relationship with the company to whom they entrust their money and are capable of assessing the financial soundness. Other "professional market parties" are not deemed to be the "public." Whilst this is an undefined term, there is reference to such persons needing to evidence sufficient expertise and funds to conduct their own counterparty research. One might assume this refers to those parties that are not categorized as MiFID retail clients. It is unclear how this will impact HNWI or other financial services activity for the mass affluent;
- Clarification that "grant credit for own account" means that... "the granting of credits or loans, must be carried out by the credit institution 'for its own account.'" The credit institution is therefore the creditor, while the credit/loans that it grants become its assets." A cross-reference to Annex 1 of the CRD IV is made as to what financial activity/products are covered. The GLAG also specifies that overdrafts can qualify as credits under the CRR/CRD IV Framework.

It is not clear whether non-Banking Union EU member states, all of which embed the CRR/CRD IV Framework, will use the GLAG's guidance and clarifications of these terms.

[14] judgment of the Court of Justice of the European Union, Case C-366/97, 11 February 1999.

[15] Directive 2014/49/EU of the European Parliament and of the Council of 16 April 2014 on deposit guarantee schemes, as implemented into national law.

Part I: The GLAG's key provisions

The GLAG specifies, including by using hypothetical examples, the processes and the stages in the license application process. This SSM process can take up to 12 months from submission to complete. In summary, these SSM stages run from:

A. The pre-application stage;

B. To the submission to and verification by the national authority;

C. The subsequent assessment of the national authority's dossier in respect of the BUSI applicant by the ECB-SSM;

D. The issuing of a supervisory Decision by the ECB-SSM, which like any SSM Decision may impose "ancillary provisions" on the BUSI. These include the option of the SSM to set an "obligation" i.e., a requirement or restriction that applies for a set period; a "condition," i.e., a pre-requisite that needs to be fulfilled prior to granting of the license; or a "recommendation," i.e., a non-binding suggestion or an "ex ante commitment" which are binding conditions subsequent; and

E. Following the application of the Decision, the handover to "ongoing supervision" and the SREP process.

Throughout this SSM process, the national and ECB components apply the following four general licencing principles to the "common procedures". These are:

1. **Gatekeeper:** the ECB-SSM acts as a gatekeeper[16] in assessing whether a credit institution applicant should receive a license. The SSM focuses on a BUSI applicant's:
    a. Capital levels;
    b. "Program of operations" (which is being separately consulted upon in a forthcoming publication that we will cover);
    c. Structural organization (including IT and outsourcing arrangements);
    d. The suitability of managers (conducted by the ECB-SSM for direct and indirect BUSIs); and,
    e. Suitability of relevant direct and indirect shareholders (see also our Client Alert on the F&P Guide) their qualifying holdings[17] and any significant influence.

2. **Open and complete communication:** The "supervisors" i.e., ECB-SSM and national level, expect each: "...applicant to accurately and completely prepare their application and openly and swiftly share information to help the supervisors reach an informed decision. The information requirements are based on the EBA's RTS and ITS on the information required for the authorization of credit institutions." This may mean that for a number of process, previously dictated by jurisdictional specifics, there is a much more centralized tone in when and how communication is expected. The same also applies in relation to the "supervisors'" information requests and communication with the BUSI applicant. Quite importantly, and following some very public statements on the lacking degree of completeness of applications received to date, the GLAG includes a new paragraph clarifying that delays in processing an application are mostly due to incomplete information or insufficient details provided by the applicant in connection with the authorization;

3. **Consistency[18]:** The GLAG aims to improve harmonization of supervisory approaches, rule interpretation and application in respect of license applications. It applies to new or extended authorizations and will not lead to a re-assessment of existing authorizations that pre-date the GLAG's publication in its final form; and

4. Case-by-case assessment and proportionality: as with certain other SSM Guides, the GLAG states that whilst "all relevant circumstances will be taken into account" it will include considerations of risk-based proportionality.

These principles, together with the contents of the GLAG, specify that the license application review process will assess whether the BUSI applicant has sufficient substance in terms of presence and resources. An assessment of substance will also look at whether the applicant is actually "sufficiently engaging in activities that it must undertake in order to be defined as a credit institution within the meaning of EU law."

16 and as a gatekeeper will probably need to continue to grow its supervisory staff and how it embeds technology in order to ensure it can deliver on heightened workload against compact deadlines.

17 or, in the absence of qualifying holdings, the ECB-SSM will apply EBA standards to assess the 20 largest or possibly all shareholders. To briefly recap, for Banking Union purposes a participation in a credit institution will be a "qualifying holding" when it represents 10% or more of any shares and/or voting rights in the credit institution. A supervisory notification of that first 10% threshold and any relevant threshold above is required. This is in addition to any other supervisory reporting required in a respective jurisdiction.

18 Previously presented as "harmonization" in the draft version.

These assessments will direct how the ECB-SSM rates the business model viability of the BUSI at inception. That analysis will in turn flow into the Supervisory Review and Evaluation Process (SREP) as a key supervisory tool used by the SSM to monitor BUSIs. The ECB-SSM-led SREP tool is itself in the process of being rolled-out to a much wider body of BUSIs.

License exemptions and lapses

The GLAG provides clear and definitive conditions[19] when an initial license application, a change in activity, a change in legal form or an extension of a license application will be required. The GLAG also specifies when an exemption to the license requirement applies or when a license lapses.

One key exemption to the need for a license that the GLAG clarifies is in the context of a merger. Where a merger exists for a "legal second" whether due to commercial or regulatory (i.e., BRRD and/or SRM) relevant measures, no license application will be required by the ECB-SSM. Certain national requirements may however still be relevant and applicable.

The ECB-SSM defines a "legal second" as the length of time "...needed to complete the transactions involved..." and the SSM will take account the specific circumstances prior to assessing whether a license application exemption can be applied or whether a special "Bridge Bank" license is required. It is important to note that an exemption request does not replace the need to obtain all other regulatory, supervisory and SSM-specific consents. This also extends to the continued need to obtain relevant merger or change in control consents irrespective of an SSM license exemption.

A license that has been issued by the SSM to a BUSI will lapse where the BUSI does not make use of the authorization for 12 months. A license will also lapse if the BUSI has ceased to engage in business for more than six months. The wording in the GLAG is not entirely precise, but this is taken to mean consecutive months and also cross-refers to the "sufficient substance and engagement" tests that were assessed as part of the initial application and business model viability assessment. It is not yet clear whether a lapse in one area will cascade through to other areas. Moreover, it is also not clear, whether a lapse or withdrawal of a SSM license might have knock-on effects to any licenses that the BUSI holds from other regulators. A BUSI may also withdraw its application or expressly renounce its authorization.

Part II: The FLAG's key provisions

The FLAG exclusively applies to those BUSIs that qualify as FCIs. A, FCI is a credit institution whose "...business models in which the production and delivery of banking products and services are based on technology-enabled innovation." The ECB's current term of what is and what is not FinTech, is different to that of the EBA and instead uses the definition set by the Financial Stability Board. Leaving aside the fact the differences between definitions, for Banking Union purposes the definition that will be in the final version of the FLAG is important. This is the case as the definition sets who might qualify as a FCI and thus be subject to the FLAG's additional provisions, which supplement the provisions contained in the GLAG.

As an overarching supervisory principle, the ECB-SSM's scrutiny of FCIs aims to focus on ensuring that they are properly authorized, have suitably qualified members of the management body, suitable ownership structures and have in place risk control frameworks that anticipate and respond to the FinTech-specific and other non-FinTech risks that arise in their field of operations. The FLAG, in supplementing the GLAG, aims to balance the creation of a FinTech friendly supervisory environment whilst at the same time ensuring that proactive (systemic) risk management and resilience measures are not compromised. Additional obligations and measures that are relevant to and which may be imposed upon FCIs, may also extend to FCIs having to hold additional regulatory capital.

Those additional obligations are however driven by firm-specific as opposed to business sector specific attributes. Moreover, the FLAG is not only jurisdiction agnostic but also describes itself as "technology-neutral" in that it does not favor traditional banking sector activity and actors over those using FinTech. Whether this will be the case in relation to the supervisory experience of FCIs remains to be seen. What is certain is that the FLAG aims to nurture FinTech's "oaks" and weed out a field of tulips. This means that FCIs will need to evidence a large amount of self-assessment on risks specific to it, risks that it contributes to its peers and the financial sector as a whole and how these are managed.

So what does this mean in practice? FCI applicants and potentially some existing BUSIs that heavily use FinTech in connection with their regulated activity are encouraged by the FLAG to:

- Sufficiently detail evidence of the technological knowledge of members of the management body;

[19] Including where an entity wishes to become a credit institution or where two or more institutions merge to form a new entity.

- Consider appointing a Chief Information Technology Officer as a member of the executive board of the FCI;
- Ensure that any business incubators and/or providers of seed capital or other growth capital are aware of the fact that their holdings, financial soundness, reputation and shareholder and own corporate governance and other specific attributes will be reviewed as part of the authorisation process of a FCI – it is interesting to note that fundraising via initial coin offerings and/or token generating events are not explicitly included even if the ECB-SSM has its own supervisory reservations there;
- Engage in sufficiently clear dialogue with the SSM in relation to change of ownership models as the FCI grows. Dilution of founding capital investors will need to be managed as qualifying holdings and/or direct and indirect significant influence relationships change;
- Account for the fact that FCIs will be subject to heightened post-authorisation supervisory reviews, in particular in relation to evaluating credit-granting and scoring methodologies (especially where provided by a third-party vendor), collateral and security arrangements, and internal governance arrangements including compliance with the ECB-SSM's non-performing loans and exposures supervisory Guide i.e., rules;
- Detail the adequacy of their resourcing needs. This applies to regulatory and economic capital as well as to sufficient human capital. FCIs are specifically expected to be able to evidence they are able to cover start-up losses for the first three years of activity. Foreseeable losses and the break-even point are to be communicated in the application;
- Evidence robust and resilient IT arrangements, data governance and cyber-resilience processes and policies. This applies in relation to traditional regulated and non-regulated outsourcing and delegation arrangements as well as cloud outsourcing; and
- Prepare, depending on the nature of the business and the BUSI applicant, an "exit plan," which is presented at the request of supervisors and which covers how an FCI would plan to cease its own business operations on its own initiative. Cessation should occur in an orderly and solvent manner, without harm to consumers nor disruption to the financial system nor regulatory/supervisory intervention. Costs of the exit plan, including how to close without imposing losses on depositors is to be covered by the FCI's "own funds" component of its regulatory capital. The final version of FLAG, unlike the draft version, no longer requires that the SSM (both ECB and national components) will consider performing a follow-up inspection one year after an FCI is licensed to assess whether the FCI is operating as envisioned in its application or whether an exit plan needs to be triggered.

Outlook and some next steps for existing and applicant BUSIs needing to follow either or both of the Guides

For applicants looking to establish themselves as BUSIs and specifically those as FCIs, the two supervisory Guides, together with the F&P Guide provide:

- A much clearer roadmap of what areas applicants and their advisors ought to highlight in their license applications; and
- The process stages and supervisory touchpoints that are relevant in respect of the license applications.

For existing BUSIs, the GLAG and the FLAG provide clarity:

- On where supervisory scrutiny, specifically in relation to entities that may evidence similar traits as FCIs, will lie in terms of SREP and any on-going supervisory inspections. One might expect a degree of focus on BUSIs evidencing sufficient financial sector and technological knowledge;
- On what circumstances might require creation of an exit plan for FCIs; and
- On forthcoming areas where the ECB-SSM will continue to drive harmonization. This will occur either by eliminating national options and discretions in the CRR/CRD IV Framework, as applied in the Banking Union, or by rolling-out rules. Both of those approaches rest on the continued use of "Guides" that, whilst drafted as being "non-binding" and "not legal," a method used in order to get these approved by relevant stakeholders, are very much reflective of supervisory expectations and instructions to be used in "supervisory dialogue" with BUSIs. Such roll-outs apply typically to BUSIs where the ECB component of SSM is the lead supervisor as well as to the much wider body of BUSIs than those that are directly supervised by the ECB component of the SSM.

The SSM distinguishes between those BUSIs that are "Significant Credit Institutions," and thus subject to direct ECB-SSM supervision and those that are "Less Significant Institutions," and thus subject to indirect ECB but direct national supervision. It is important to note that most FCIs are likely, for SSM purposes, to qualify as "high-priority Less Significant Institutions" (HP-LSIs). This means that the ECB component of the SSM will indirectly supervise and the national components of SSM will directly supervise the FCIs. HP-LSIs receive

closer scrutiny from the ECB component of the SSM. Most FCIs are likely to be categorized as HP-LSIs due to their supervisory importance and perceived firm and/or systemic risk contribution. Whatever the BUSI type, the GLAG, the FLAG along with the other SSM rulemaking instruments and supervisory "Guides" are likely to assist both the SSM and BUSIs in ensuring a more level playing field can take root.

If you need assistance with an existing or new, including an FCI license application or if you would like to receive more analysis from our wider Eurozone Group in relation to the topics discussed above, including what other SSM rules might mean for specific market participant types within or looking to enter the EU and/or the Eurozone, then please do get in touch with any of our Eurozone Hub key contacts below.

Your Eurozone Hub Contacts:

Michael Huertas
Partner
Frankfurt
D +49 69 45 00 12 330
michael.huertas@dentons.com

Dr. Markus Schrader
Counsel
Frankfurt
D +49 69 45 00 12 362
markus.schrader@dentons.com

Dr. Katja Michel
Senior Associate
Frankfurt
D +49 69 45 00 12 272
katja.michel@dentons.com

Brand-9086-News article ECB-SSM-02 – 14/05/2018