EUROPEAN CENTRAL BANK

BANKING SUPERVISION

Draft guide to assessments of licence applications – Part 2

Assessment of capital and programme of operations

September 2018

Contents

1 Foreword

On 23 March 2018 the ECB published its Guide to assessments of licence applications[1] (hereinafter referred to as the “Guide” or “Licensing Guide”). The Guide sets forth general licensing principles with regard to the scope of the licensing requirement and the assessment of licence applications.

This Part 2 shall be considered an integral part of the Licensing Guide and contains specific guidance on the ECB’s supervisory expectations regarding the capital required for a newly licensed bank and its programme of operations.[2] The Guide and this Part 2 should therefore be read together as one document.[3]

As such, the general licensing principles and scope of the licensing requirements which apply to the Guide also apply to this Part 2.

As for the previously published Licensing Guide, the purpose of this part 2 is to enhance transparency for potential applicants and increase their understanding of the procedure and criteria applied by the ECB in its assessment of licence applications. This transparency is also intended to facilitate the application process. The Licensing 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 authorisation to ensure a smooth and effective procedure and assessment.

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1 Guides to assessments of licence applications for banks and fintech credit institutions.

2 This guidance corresponds to Section 5.1 on capital and Section 5.2 on the programme of operations of the Licensing Guide.

3 Therefore, this Part 2 to the Guide also applies to licence applications from fintech entities.

2 Legal Framework

This Part 2 to the Guide is subject to the same legal framework as referred to in paragraph 2 of the Guide. The articles of the SSM Regulation,[4] the SSM Framework Regulation[5] and the CRD IV[6] cited in the Guide also apply to this Part 2.

Furthermore, this Part 2 reflects policies that the ECB has developed together with the national competent authorities (NCAs) regarding practices and processes with respect to the Single Supervisory Mechanism (SSM). It takes into account the Final report on draft Regulatory Technical Standards under Article 8(2) of the CRD IV and draft Implementing Technical Standards under Article 8(3) of the CRD IV (EBA/RTS/2017/08 and EBA/ITS/2017/05), developed by the European Banking Authority (EBA), that will be binding on the ECB once adopted by the European Commission in accordance with Articles 10 to 15 of Regulation (EU) No 1093/2010.

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4 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 (OJ L 287, 29.10.2013, p. 63).

5 Regulation (EU) 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) (OJ L 141, 14.5.2014, p. 1).

6 Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (OJ L 176, 27.6.2013, p. 338).

3 Assessment of licence applications

3.1 Capital[7]

As part of the assessment of licence applications, supervisors evaluate the amount, quality, origin and composition of the applicant credit institution's[8] capital. The supervisors assess capital needs for all applications, regardless of whether they concern an initial authorisation, an authorisation in the context of a merger, an acquisition, a bridge bank application or an extension of the scope of an existing authorisation. The assessment of capital needs takes into account the situation at the time the authorisation is considered, as well as the projected capital needs over a specified period.

Differences have been observed between NCA practices for determining the level of capital needed. Therefore, it is worth clarifying two underlying concepts:

Initial capital requirement

The initial capital requirement refers to the absolute minimum amount of capital that a credit institution is required to have under national law. Initial capital must be paid up in full at the time the authorisation is granted[9] and must subsequently be maintained over the credit institution's lifetime, in accordance with Article 93 of the CRR. The CRD IV sets the minimum amount of initial capital at €5 million[10]. In transposing the CRD IV into their national laws, some Member States have established a higher threshold for the initial capital. In such cases, this higher threshold is used to determine the initial capital.

Own funds requirement

The own funds requirement refers to the amount of capital that a credit institution must maintain after authorisation, in order to absorb possible losses and mitigate the risks inherent in its activities. The own funds requirement is estimated at the time of authorisation, based on the applicant's business plan and its projected credit, operational and market risk-weighted assets. It applies both to stand-alone entities and to groups subject to consolidated supervision.

7 This section corresponds to Section 5.1 on capital of the Licensing Guide.

8 Depending on the particular circumstances of each case, the applicant is not always the entity to be authorised as a credit institution; it may, for example, be the proposed shareholder(s) of a legal entity to be established once the authorisation has been obtained.

9 Except where national law explicitly prevents the minimum initial capital from being paid up in advance, in which case a condition precedent can be added to the ECB's decision whereby the authorisation becomes effective only after the initial capital has been paid up in full.

10 There are some specific exceptions to this provision. For details, see Article 12(4) of the CRD IV. For certain categories of credit institution, the minimum initial capital requirement may also be lower than €5 million.

Quality of capital

Pursuant to Article 72 in conjunction with Article 25 of the CRR, the own funds of an institution consist of the sum of its Common Equity Tier 1 capital (Articles 26 to 50 of the CRR), Additional Tier 1 capital (Articles 51 to 61 of the CRR) and Tier 2 capital (Articles 62 to 71 of the CRR)

To ensure consistency when assessing the strength of a credit institution's capital base, the rules on what can be included in its constituent elements have been harmonised. The CRR defines which capital instruments and items can be recognised as elements of own funds.

During the assessment the supervisors verify that the capital is composed of recognised elements, thus ensuring the quality of the capital.

The credit institution's capital is expected to be clearly segregated from other owner assets, as it must remain fully available and for the unrestricted sole use of the credit institution.

Quantity of expected capital at authorisation

The supervisors evaluate the credit institution's capacity to maintain a sufficient level of capital over a specified time period, typically three years. To this end, they assess the applicant credit institution's business plan and evaluate the activities that will be undertaken and the related risks.

The ECB expects the credit institution's capital at authorisation to be sufficient to absorb losses resulting from its risk exposure over this time period.

The business plan is expected to contain a central scenario and a severe, but plausible, adverse scenario for the first three years of operation. As part of the overall assessment of the business plan, the supervisors review and challenge the projections under its central and adverse scenarios.

As standard practice, in order to determine the level of expected capital at authorisation, several calculations are performed and their results are compared:

- First, the applicant estimates the own funds requirement for each of its first three years of activity and the highest of these three amounts is identified.
- Second, this amount is compared with the initial capital requirement under national law to determine which of the two is highest.
- Third, the projected cumulative losses (if any) in the first three years of activity under the credit institution's central or adverse scenario (whichever are higher) are added to the highest amount identified in the second step. These three steps form the basis for the calculation of the total amount of capital that a credit institution is expected to have available at authorisation (i.e. the "expected capital at authorisation").

The calculation of the expected capital at authorisation is based on the applicant's business plan and its underlying assumptions over the first three years of activity. The aim is to establish a level of capital that seeks to ensure the compliance of the credit institution with the estimated capital requirements during its first few years of activity.

For this purpose, it is common practice for the competent authorities, including the ECB, to apply an additional individual risk-based buffer to the initial capital requirement. This is because the initial capital requirement must be maintained over the credit institution’s lifetime, and cannot be used to absorb any potential losses.

Therefore, the expected capital at authorisation is defined not only as the level of capital that guarantees compliance at that specific point in time, but also as the level of capital that guarantees compliance with both the own funds requirement and the initial capital requirement during the first few years of activity.

Availability of capital

A distinction is made between the part of the expected capital at authorisation to be paid up in full at the time of authorisation and the remainder, which can be covered by capital resources.

The highest amount of either the initial capital requirement or the own funds requirement, plus the losses in the first year of activity, as projected by the applicant, form the basis for the calculation of the amount that it is expected to be paid up in full at the time of authorisation.

The ECB expects the difference between the amount to be paid up in full at the time of authorisation and the expected capital at authorisation to be covered by capital resources available at the time of authorisation.

Capital resources are defined as assets that are reliably available to the applicant. Upon verification by the supervisors, the following may be included as capital resources: borrowed funds, letters of guarantee, shareholders’ private financial resources, and financial instruments issued or to be issued on financial markets, etc. The applicant is expected to demonstrate the availability of these additional resources.

Examples

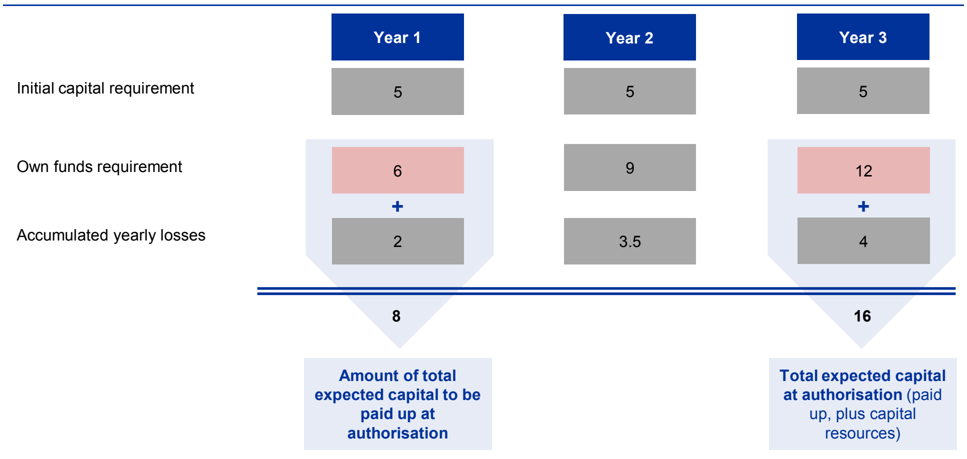
The examples below illustrate the variations in the total capital expected at authorisation that can occur due to certain Member States having established a higher threshold for the initial capital requirement, and the distinction between paid up capital and the total expected capital.

Example 1: The own funds requirement surpasses the initial capital requirement

In this example, the own funds requirement is estimated to be consistently higher over the first three years than the initial capital requirement. The highest amount reached by the own funds requirement – 12, in the third year – is added to the projected cumulative losses of the first three years – i.e. 4 – for a total of 16, which is the amount of capital expected at the time of authorisation of the credit institution (including capital resources). The amount of capital expected to be paid up at authorisation in this example is 8 (made up of the estimated own funds requirement in the first year – 6 – plus the projected losses in the first year – 2).

Figure 1

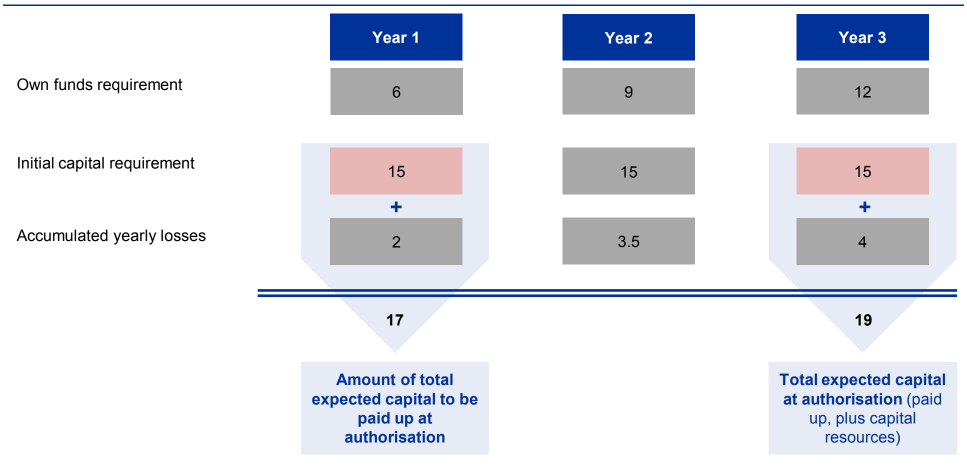
The own funds requirement surpasses the initial capital requirement



Example 2: The initial capital requirement under national law surpasses the own funds requirement

In this example, the initial capital requirement – 15 – is consistently higher over the first three years than the own funds requirement. Since 15 is the highest amount, the amount stemming from the initial capital requirement is used for the calculation, rather than the amount stemming from the own funds requirement. Therefore, 15 is added to the cumulative losses of the first three years – 4 – for a total of 19. In this example, 19 is the amount of expected capital at the time of authorisation of the applicant (including capital resources), while 17 (initial capital of 15, plus the projected losses in the first year – 2) is expected to be paid up at authorisation.

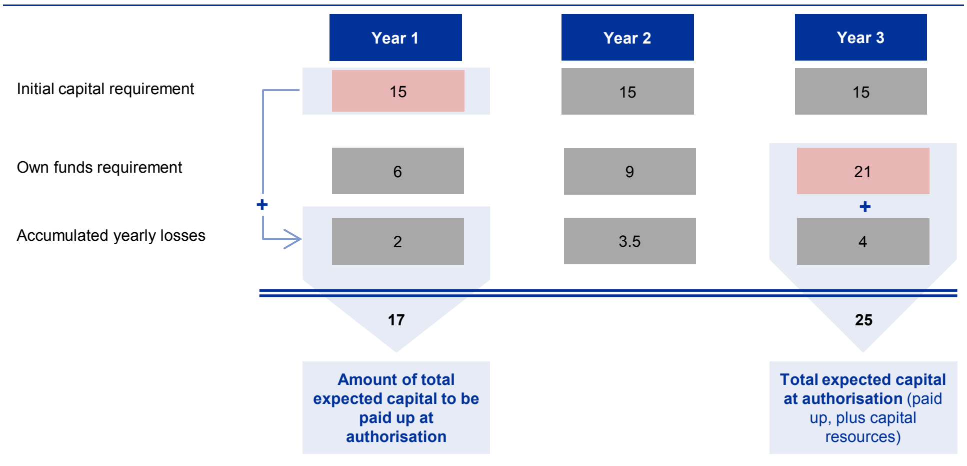
Figure 2
The initial capital requirement under national law surpasses the own funds requirement



Example 3: there is a switch in the highest amount used

In this example, the projected own funds requirement grows rapidly and surpasses the initial capital requirement in year three. This highest amount – 21 – is added to the projected cumulative losses of the first three years – 4 – for a total of 25, which is the amount of capital expected at the time of authorisation of the applicant (including capital resources). The expected amount of capital paid up at authorisation – 17 – is the same as in the previous example.

Figure 3
There is a switch in the highest amount used



Note that the highest amount to be used as a basis for the calculations can also occur in year one or two, unlike in the examples above.

Moreover, additional capital can be requested by the supervisors at the time of authorisation if specific risks need to be covered, e.g. “start-up risk” or “execution risk”, depending on the individual circumstances based on a case-by-case analysis.

Location

The required capital paid up in full is expected to be present on the books of the credit institution, unless national law provides otherwise.

Timing

It is advisable for the full amount of the expected capital to be paid up in full prior to the granting of authorisation. However, if, owing to national laws or practices, this is not feasible, the initial capital should be fully paid up prior to authorisation, or at least before the commercial launch of activities.[11].

Evidence of the payment or transfer of the capital is expected to be submitted to the supervisors, if required under national law.

Banking groups

In some cases, newly authorised banks are part of an existing banking group. The newly authorised subsidiary may have an impact on the capital levels of the group, depending on its size and activities. When assessing the potential impact of a newly authorised entity on a banking group, the existence of waivers will be taken into account.

Waivers can be granted by the competent authorities and permit the newly authorised entity to be exempt from capital and/or liquidity requirements on a stand-alone basis. Instead, the newly authorised bank’s requirements will be integrated into the prudential consolidation scope of its parent company.

If it is intended that the credit institution is to be exempt from capital and/or liquidity requirements on a stand-alone basis, the waiver decisions need to be adopted prior to authorisation, or at the same time as authorisation is granted, in order for the waiver to apply with effect from the time of authorisation.

Typically, waivers are granted at the time of authorisation in cases where the applicant and/or its parent are already supervised institutions.

[11] The commercial launch of activities is understood as being the point in time when the credit institution begins to market its offer with a view to attracting customers.

Bridge banks

As a general rule, newly licensed bridge banks also have to comply with capital and liquidity requirements.

Owing to the inherent uncertainties for bridge banks regarding valuation and costs, the supervisors, following a case-by-case assessment, may set the post-resolution capital requirement higher, or lower, than for the predecessor entity.

In general, the bridge bank should conserve the same percentage of capital as it had under its former incarnation, taking into account a prudent valuation of the assets, rights and liabilities transferred to it, until a full assessment under the Supervisory Review and Evaluation Process (SREP) can be carried out.

3.2 Programme of operations and structural organisation[12]

After the adoption of the draft RTS by the EBA, the information to be provided as part of the licence application will become more specific and will include comprehensive documents and details covering a wide range of topics.

While the following list is not exhaustive, it indicates the main topics of interest to supervisors in the assessment of the programme of operations and business plan.[13]

The supervisors can challenge the information submitted in order to test the assumptions that form the basis of the business plan.

The business plan is generally formulated over the medium term, i.e. over a three to five-year horizon.

Proposed activities and strategy

In order for the competent authorities to assess the business model and associated risk profile, the applicant is requested to submit information regarding the proposed activities to be carried out, in accordance with Article 10 of the CRD IV and national implementing legislation. The applicant is expected to describe the overall strategy as well as the identified steps to attain the strategic goals of the credit institution.

The supervisors assess the information contained in the business plan regarding the products and services to be offered, the segment and location of targeted customers, the physical and/or digital distribution channels and the intended market positioning vis-à-vis competitors.

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12 This section corresponds to Section 5.2 on the programme of operations of the Licensing Guide.

13 When appropriate, and where allowed by national law, the supervisors may request the submission of further documentation, for example: an exit plan describing an orderly winding-down of credit institution activities without default.

When reviewing the schedule for the implementation of the proposed business plan, the supervisors will take into account the content, priorities and deadlines of the various planned steps, as well as the fixed and variable costs stemming from the implementation.

The application is expected to also include information about the planned adhesion to a deposit guarantee scheme and institutional protection scheme, as applicable.

Economic environment and business model viability

The supervisors assess the situation of the credit institution within the macroeconomic context while also taking into consideration the business environment.

The environment provides context for the supervisors to understand the key assumptions on which the projections are built. The supervisors will often challenge the underlying assumptions, in order to ensure that they are realistic and that the projections are achievable.

The viability of the business model is assessed by looking at key profit drivers and the ability of the entity to generate adequate returns over the first three years of activity. In addition, the supervisors assess the sustainability of the credit institution's business model by looking at its capacity to generate future profits and its expected risk profile over the business plan horizon.

Financial projections

The assessment of the financial projections is based on the forecast balance sheet and profit and loss account statements covering at least three full years of activity provided by the applicant.

The projections are expected to contain a central, or base-case, scenario, as well as an adverse scenario, in order for the supervisors to assess the viability and sustainability of the business model under different conditions. Both scenarios should explain the assumptions behind them, why they were chosen, and why they are considered realistic.

Both scenarios are expected to show the impact on capital and liquidity ratios.

The financial information provided is expected to also describe the applicant's funding profile, its diversification and any applicable sources of financing and/or any indebtedness incurred.

The financial projections form the basis of the assessment of whether the amount and quality of capital provided by the applicant is sufficient to absorb losses stemming from the credit institution's risk profile, including the projected losses under the adverse scenario.

Organisational structure

When assessing the clarity and effectiveness of the organisational structure of the credit institution, the supervisors look at the organisation not only of the operational staff, but also of the management layers.

The assessment evaluates whether the overall organisation allows the credit institution to perform its activities in an effective, responsible and controlled manner.

The supervisors pay attention to the allocation of tasks and the reporting lines, as well as the organisation and the qualitative and quantitative composition of the risk management and control functions.

Governance arrangements

The governance arrangements of an institution are part of the corporate structure, and contribute to whether it can be considered “fit for purpose”.

The assessment of the governance arrangements looks at the composition and role of the management and supervisory bodies, including the relevant committees. This includes an evaluation of their compliance with national law.

The governance structure is assessed against the criteria of transparency, robustness and its ability to ensure effective decision-making with clear allocation of powers and responsibilities at all levels.

Furthermore, according to the relevant Union and national law, the governance arrangements must ensure adequate checks and balances, protect the management body against undue influences and enable conflicts of interest to be identified.

Internal control and risk management framework

According to the relevant Union and national law, the internal control and risk management framework must comprehensively cover the credit institution’s activities and incurred risks. In order to assess this framework, the supervisors look at whether the applied policies and methodologies enable risk to be effectively identified, measured and monitored, including for outsourced activities.

As a general principle, the risk management, compliance and internal audit functions should be adequately staffed, both in terms of numbers and of competence. Therefore, the assessment will take into account the size of the functions compared with the scale and complexity of the credit institution, the geographical location of the functions compared with the location where the activities are actually performed by the credit institution, and whether the internal control and risk management framework has sufficient technological means at its disposal.

IT infrastructure, including business continuity planning

Credit institutions rely heavily on information technology to support business operations, particularly when providing online and/or mobile banking services. Therefore, it is important that the IT infrastructure is robust and that relevant steps have been taken to plan for business continuity.

The supervisors evaluate the capacity of the IT infrastructure to meet its current and future business requirements, under normal circumstances and in periods of stress.

The credit institution is expected to have in place appropriate policies and processes for identifying, assessing, monitoring and managing its IT risk.

The business continuity plan, including IT disaster recovery, is evaluated to gauge its capacity to provide adequate resilience and maintenance of critical operations in the event of severe disruptions.

Outsourcing arrangements

Activities that are outsourced are considered riskier, whether they are outsourced within the credit institution’s group, or to third-party providers. These activities therefore come under particular scrutiny and the assessment takes into account, inter alia:

- the nature of and rationale for outsourced activities;
- the experience, track-record and location of the service providers;
- the soundness of the outsourcing policy and its impact on risk management, in particular for cross-border arrangements; and
- the contractual arrangements in the form of service level agreements.

Supervisory regime

Licence applications are assessed with the principles of consistency and level playing field in mind.

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For specific terminology please refer to the SSM glossary.