ECB Guide on consolidation in the banking sector

A supervisory view on M&A

October 2020

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ECB objectives

The Guide aims at increasing transparency in the assessment process for M&A transactions in the banking sector

- On July 1st 2020, **ECB** published the **guide** on the supervisory approach that will be adopted for the assessment of **consolidation projects** within the European banking sector (i.e. M&A transactions, excluding intra-group deals)
- The guide will be under **consultation** until **October 1st 2020**

Objectives

01 **Clarify** the **supervisory tools** adopted to assess **consolidation transactions**

02 **Enhance** the **predictability** of supervisory actions, **reducing** some elements of **uncertainty**

03 **Foster sustainable operations** to achieve **economies** of **scale** and **address** new **challenges** (e.g.: digitalization)

Supervisory approach

The assessment process consists of 3 phases and it clarify the ECB expectations on M&A transactions

The process to consolidate

1 Early communication

- **Initial exchange *of information*** with ECB
- Request for **preliminary feedback**
- **Analysis** of the main features of the **business combination**

2 Application

- **Submission** of the final **integration plan**
- **Notification** of a proposed acquisition of a **qualifying holding or formal application** to obtain permission for the business combination

3 Implementation and monitoring

- **Implementation** of the integration **plan**
- **Ongoing monitoring** and **reporting** to ECB

Supervisor expectations

- **Solid** and **conservative business plan**
- **Sustainable business model**, even under an adverse scenario
- **Compliance** with **regulatory** and **prudential requirements** at all times
- Ongoing **compliance** with **high standards** in terms of **governance** and **risk management**

Benefits for banks involved

Banks involved in consolidation projects will be able to apply favorable and measurable prudential treatments

Key points	Description
P2G and P2R	• **Pillar 2 requirement** and **guidance** based on the actual risk profile of the combined entity • ***Calculation of target P2R and P2G levels starting from the weighted average of the P2R and P2G levels applicable to the two entities prior to the consolidation*** • ***Starting point adjustable by the supervisor upwards (e.g.: in case of complex IT integrations) or downward (e.g.: in case of documented diversification of the combined portfolios)***
Badwill	• **Recognition** of the accounting value of **badwill** generated by the transaction • ***Recognition subject to the priority use of badwill to increase the sustainability of the new business model (e.g. provisioning for NPL, covering of integration costs or other investments)*** • ***No distribution of profits from badwill to the shareholders until the sustainability of business model is reached***
Internal models	• **Temporary approval** to continue using **internal models** that were in place before the merger, notwithstanding the principle of **non transferability** of approval from one entity to another • ***Use of internal models subject to a clear model mapping and a credible internal model roll-out plan***

What shall banks do?

Guidelines provide with some clear and actionable indications on how an M&A transaction shall be designed and implemented

1 Carefully design the Deal

- Select a “**target**” or a **business combination** that can generate **Value Creation** through **industrial synergies**, ensuring **post-deal sustainability** and **profitability**
- Show that the **badwill generated** will **contribute** to the **sustainability** of the **business model** and **define** its **allocation** (eg.: increase providioning, conver integration costs…)
- Focus on **post deal regulatory** and **risk** ratios: profitability, asset quality, capital & liquidity profile
- Carefully **design** the **deal**: prepare a robust **business plan**, identify all key steps of the **implementation plan**, identify key steps to **align internal models** where applicable

2 Execute the Deal in alignment with expectations

- Plan an **accurate *due diligence*** process (when applicable)
- Provide an **accurate** set of **information** to the **Supervisors** and to the **market** on **rationales**, **impacts** and **expectations** of the **M&A process**
- **Adapt** the **plan** (business plan and implementation plan) rapidly to **new information** emerging from the process

3 Ensure a smooth post-deal

- Prepare **accurate tools** to **monitor** the **advance** in the **post-deal activities** and promptly **inform** Supervisors of any **deviation** and of the consequent **remedial actions**
- **Focus** on **internal model** implementation to the **new entity**, when applicable
- Ensure a **proper governance** from **“Day 1”**: **suitable management**, **proper control functions**, **reliable board**

Points of attention

In some areas the guide leaves some room for interpretation and attention shall be made to some key issues

Areas	Brief description	Areas of attention
Integration plan	• Partial **flexibility** in the definition of the **contents** required by the **integration plan** submitted for approval to ECB • Application of a **case-by-case approach**	**How to build an effective integration plan satisfying the expectations of the Supervisor?**
P2R and P2G weighted average	• References to the level of **P2R** and **P2G** post consolidation but **without quantitative details** on the **methodology** to calculate them • Only **qualitative information** regarding potential upward or downward **adjustments** to the starting points for Pillar 2 requirements	**Which assumptions on post consolidation P2R and P2G levels?**
Badwill recognition	• **Potential uncertainty** related to the **evaluation** of badwill, in case there is specific supervisory evidence of valuation issues not yet recognized • Potential use of **goodwill** on different **areas** (eg.: to increase provisioning, to cover integration costs); which **allocation** will lead to a more **sustainable plan** and to **lower prudential requirements**?	**How to ensure badwill is effectively generated and properly allocated?**
Internal models roll-out plan	• Possibility to use internal models upon **definition** of a **roll-out plan**, but no details about the expected **structure** and **contents** of such plan, *also considering* **different possible scenarios** (only one bank / more than one bank authorized)	**Which procedures to be followed under different possible scenarios?**

PwC support

PwC network offers an integrated advice on M&A based on a strong expertise in identifying industrial and regulatory synergies

*PwC network, thanks to the **integrated skills** in all the stages of an M&A transaction, will be able to guide its clients in **finding** the **opportunities** to create value and in **identifying** the **synergies** both at **industrial** and **regulatory** level*

Key activities in M&A transactions

1
- **Screening** of business combination **opportunities**
- **Definition** of **targets** for the transaction
- **Preliminary analysis** of the economic, legal and tax **implications**

2
- **Drafting** of the **business plan** and **integration plan**
- **Due diligence** and **valuation** of the transaction
- Preparation of the **documentation** for the supervisor

3
- **Start** of **early communications** with the supervisor
- Follow up on possible **requests** for **additional** information
- **Trigger** of **formal procedures** for the approval request

4
- **Execution** of the **integration plan** (e.g.: integration of **IT** systems and **internal tools**, review of **risk management processes** and **internal governance**, etc.)

5
- **Ongoing monitoring** of the execution and **reporting** to the supervisor

Expertise PwC

Strategy	*Strategy and business planning*
M&A e Valuation	*Advisory on transactions and their valuation*
Transaction services	*Support in financial due diligences*
Special Projects	*Expertise in prudential matters and relationships with supervisors*
Post Deal integration	*Advisory on execution and integration matters*
Tax & Legal	*Tax & Legal advisory for transactions*

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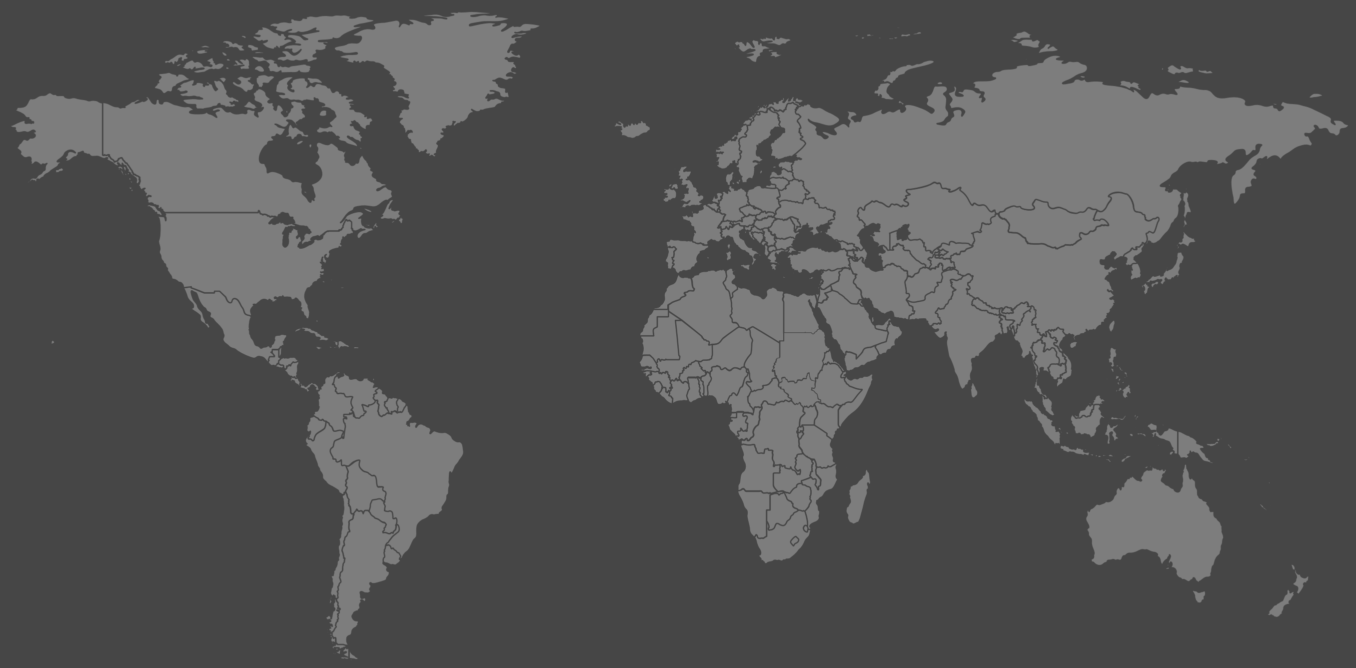

Thank you

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