Prevention and Cure: Securing Financial Stability After the Crisis
AFME / PREVENTION AND CURE: SECURING FINANCIAL STABILITY AFTER THE CRISIS
Contents

AFME Chairman’s Foreword 2
1 Financial stability and systemic risk 5
2 Corporate governance 12
3 Financial resources 16
4 Market infrastructure 20
5 Resolution and fast-track capitalisation 28
6 Conclusion 32
Annex 1: Enhanced supervision 34
Annex 2: Contingent capital and bail-in 45
About AFME 60
Contacts 60
AFME Chairman’s Foreword

The financial crisis of 2008 led global leaders and regulators to focus more than ever before on the need to manage systemic risk in the financial system. The fact that the system was carrying levels of risk that threatened its survival and could not be managed without government assistance came as a shock to many. The realisation led to state interventions on an unprecedented scale. While few would still argue against the decisions to invest substantial public funds in supporting the system through the crisis, it is clear that neither our politicians nor those they represent will accept a reoccurrence. Lessons have been learned from the crisis. Now it is time to look forward, to ensure that taxpayers need never again be called upon to bail out failed financial institutions on that scale.

This leads us to consider how to manage and regulate systemic risk, by which we mean the situation in which levels of risk being carried within the financial system and the inter-connectedness of the institutions themselves mean that the failure of one firm could endanger not only other firms but also the functioning of the entire system. As an organisation that brings together the majority of the pan-European banks, AFME believes this is essential for the protection of the wider economies that the financial system supports. Banks must be free to provide the essential services that their customers require; the challenge is to do so in a way that does not introduce excessive risk.

It is not desirable (or possible) to remove risk from the financial system completely. Even in the most tightly regulated environment firms will – and must be allowed to – fail. The optimal way forward is to develop sensible reforms that reduce systemic risk and the need for government intervention when failures occur. Such reforms would encompass: sound governance and risk management practices in financial firms; robust capital and liquidity regimes that reduce the risk of failure; effective supervision designed to identify risks early and avert institutional and systemic risk; market practices that prevent risks from building up unseen; and appropriate resolution regimes that reduce the impact of any failures.

“Banks must be free to provide the essential services that their customers require; the challenge is to do so in a way that does not introduce excessive risk.”
**The scope of our report**

In this document we set out ideas about how such a governance and regulatory regime might operate. We examine the criteria that help identify whether an individual firm or group of firms pose systemic risk and consider whether they should be regulated in a fundamentally different way. We consider the balance between “static” regulation, such as capital requirements, capital surcharges and levies, and “dynamic” regulation, such as supervision. In this context, we set out the good practices that we believe would represent an enhanced form of supervision that reduces the need for capital-based controls. We address the challenge of providing market participants with an appropriate level of certainty and transparency while ensuring that markets can serve their purpose and remain open to innovation. We also consider the factors that constitute good risk management and corporate governance in firms.

Whilst observing that failures will occur in a functioning economy, we put forward ideas for minimising the damage they cause, through effective resolution mechanisms, and detail some of the steps that can be taken, on a contingent basis, to provide the best chance for subsequent recovery. Our recent discussion paper on bail-in and contingent capital set out much of our thinking on this topic and is included as an annex to this report. These ideas have attracted interest from legislators and we believe, though not without debate, have the potential to meet many of their objectives in a way that does not require the levels of capital provision that have been put forward as the basis of other possible strategies for reducing risk in the financial system. We hope that both the industry and legislators will work together on developing them further.

We should acknowledge that the regulatory authorities have already initiated a great deal of reform, at both national and European level. Indeed, the overall structure of the European regulatory system is undergoing radical change. Some of the most significant initiatives in each field are listed at the end of each chapter, together with references to other useful sources of information or analysis.

Although the objective of reforming the regulatory framework enjoys our broad support, we have not set out to provide detailed analysis or comment upon every regulatory proposal currently under consideration. In some instances, future regulation is being developed on an incremental basis with snippets of information made available as the authorities reach decisions. This piecemeal approach makes it more difficult for the industry to respond and would render any detailed discussion in this report quickly out of date. We have instead endeavoured to focus on broad regulatory themes and to advance a considered industry view on the form an effective regulatory framework might take.

Since our focus is on the reduction both of systemic risk and the need for government interventions, we do not deal with current proposals to tax the financial sector. Some governments are currently intending to use the funds raised by these taxes to meet other spending commitments. Whether windfall taxes are economically desirable at this juncture is a separate issue, but they would not help reduce systemic risk, nor would the proceeds be available to support the financial sector.

Other proposals that would dedicate the proceeds to fund future interventions might reduce the chance that a government will need to resort to the taxpayer, but not the likelihood that an intervention would be necessary. Indeed, the existence of such a fund could create the climate of moral hazard that we are seeking to eliminate.

In short, tax is a blunt policy tool with the potential to create more problems than it solves. A better way to manage systemic risk is through precise prudential regulation combined with credible and integrated resolution regimes to manage failure.

Remuneration is also not discussed in significant detail. This is not because remuneration has no role to play in the reduction of systemic risk. Indeed the opposite is true. AFME members have acknowledged that remuneration incentives were not properly aligned with risk management and have worked toward new remuneration structures that complement the control and risk management functions. The G-20 has endorsed the Financial Stability

---

1 Our numerous responses to the various completed and current consultations are publicly available on our web site: www.afme.eu.
Board (FSB) Principles and related Implementation Standards, which strike an optimal balance between flexibility, to allow a competitive labour market to operate, and prescription, setting parameters that link remuneration to long-term performance. AFME members have already implemented – and frequently exceeded – the core provisions. In our view, little policy formulation remains to be done. Indeed, much harm could result from uneven global implementation of the FSB Principles and we urge regulators to turn instead to detailed implementation by prudential regulators in close dialogue with individual firms.

How the report was produced
As the only body representing the interests of both European banks and global banks with operations in Europe, AFME has been uniquely able to draw upon the considerable expertise found within its member firms to address systemic risk in a way that embraces and benefits from the diversity of business models, cultures and experiences in its membership.

At the instigation of the AFME Board, which is made up of senior figures from the major firms operating in Europe, a series of working groups was formed, bringing together high-level experts from member firms and other professional advisers where required. These groups were augmented by many members of standing AFME committees, as well as AFME’s own experts, to identify and consider the various elements that can introduce systemic risk.

We also consulted other industry bodies, regulators and experts, as the work evolved. Thus, we feel that this paper may represent the most wide-ranging and cohesive assessment yet from the financial sector itself of how to minimise systemic risk in the European, and perhaps global, financial system. I would like to thank all those who contributed to this work for their commitment and expertise.

Obstacles to revitalising the financial sector
Mitigating systemic risk is, of course, not the only challenge facing the industry and legislators as they try to further economic recovery. Some sectors of the wholesale markets - securitisation, for example - continue to struggle and need constructive regulatory initiatives to revive them. There are improvements to be made to market infrastructures to bring about the right levels of transparency and operational efficiency. Even based on the most conservative current projections, it is clear that large capital injections will be needed to meet impending regulatory requirements and that relationships with the Asian capital markets will become even more important in the absence of significant new capital flows from the Western economies.

However, these problems are not insurmountable and with an effective overarching governance and regulatory regime in place the outcome will be a more stable and resilient financial system that will benefit us all. This is the goal of politicians and regulators worldwide and one that is shared by AFME and its members. We see our role as supporting the relevant authorities – whether central banks, legislators or regulators – in developing a sustainable financial system, by offering our members’ insights to augment their own analysis and expertise.

I stress that in this document we do not claim to have identified the solution to every problem. On some topics there are several options that could be considered and I anticipate constructive discussion between the industry, legislators, regulators and other interested parties. AFME will be holding a conference in Brussels later in the year to provide a forum for this dialogue. I hope that our contribution will play a useful role in the ongoing debate about the future of our industry and look forward to discussing these issues with all stakeholders in the coming months.

Gaël de Boissard
September 22 2010
1. Financial stability and systemic risk

As all stakeholders consider the steps needed to develop a more resilient financial system that should never again need taxpayer funds to be used to save it, the regulatory architecture that is chosen and how it is implemented has a significant role to play in the success, or otherwise, of both the financial services industry and the wider economy.

Commentators agree that there was a “macro-prudential gap” that contributed to the severity of the last crisis. How that gap is filled at the national, European and global level is critical to the future resilience of the system and the economic prosperity of us all. This chapter focuses on certain aspects of systemic risk and details our views on some of the key areas, specifically regarding so-called Systemically Important Financial Institutions (SIFI).

There is a legitimate concern as to whether regulators will always be able to measure and react to market circumstances swiftly enough to mitigate fast-moving systemic risk, or whether they will always be capable of predicting those imbalances and risks that are likely to become critical for financial stability. If reforms in these areas are overly restrictive, disproportionate, or not sufficiently coordinated, they will create a significant drag on the financial system and, therefore, on economic growth. To continuously get the balance of these factors right will certainly be difficult, perhaps impossible, and will require ongoing adjustment as the impact and effects of policy decisions are understood. What is more certain and universally agreed is that both the industry and the regulators must work together and make every effort to get this right.

This more holistic view of risk requires a regime of coordinated macro- and micro-prudential regulation, supported by an effective, efficient and consistent supervisory programme. With such a regime in place, identifying which institutions should or should not be classified as Systemically Important need not be considered an essential regulatory objective.

Clear Objectives and Shared Understanding

A significant component of any solution will be a clear definition of financial stability and a shared understanding of how to ensure it.

Publication of agreed objectives is a valuable – and under-used – policy
1. Financial stability and systemic risk

A tool that has an important role to play in bridging the sometimes lengthy intervals between identifying issues and implementing coordinated and effective regulatory solutions. If the policy objectives and regulatory tools are clearly understood, individual behaviour and business models can be adjusted accordingly, and the need for regulatory action reduced or eliminated.

There are core principles in defining financial stability that should be universally understood:

Firstly, “financial stability” should not protect badly run firms. Firm failures are normal in a functioning economy and generally will not threaten financial stability or require taxpayer support.

Secondly, a financially stable system will always carry some risk. Participants retain the duty to assess that risk and make individual judgements, geared to individual risk appetite. The focus should be on identifying, understanding and, where possible, mitigating risk.

Thirdly, all participants – firms, customers and regulators – should share a common understanding of what is desirable in a healthy financial marketplace and whether regulatory or market solutions are the best way to achieve that vision.

There is no doubt that financial stability is a complex topic. Detailed objective setting will be most effective when it is seen to have been the outcome of a robust and challenging consultation process in which the appropriate expertise is applied to consider both the likely and unlikely, or unintended, consequences of the goals being set.

For the process to be most effective there needs to be universal buy-in not just to the objectives but also to the timeframe over which these will be achieved and to the steps that need to be taken to ensure financial stability. It is vital that a consistent policy is developed and allowed to mature and that the number of measures implemented that subsequently need to be reversed, or significantly revised, are kept to a minimum.

Systemic risk needs to be measured and monitored in the context of the defined financial stability objectives. The extent to which this can be undertaken effectively will determine the long-term resilience, and performance more generally, of the financial system. In today’s global markets any regulatory response to systemic risk must be well coordinated and evenly applied. The “squashed balloon effect” that can result from pressure being applied unevenly to parts of the system must be avoided as it allows risks to build “unseen” within the system, while at the same time provides a false sense of security.

“In today’s global markets any regulatory response to systemic risk must be well coordinated and evenly applied”
Important factors

In the global banking system and markets, where imbalances in supply and demand exist, confidence (or just as importantly a lack of confidence) will determine the scale and scope of any crisis. Market participants must have complete confidence that:

- the transactional obligations of their counterparts will be met in full as they fall due;
- the market will continue to provide a price at which there will be sufficient liquidity to transact; and
- they will, therefore, be able to continually adjust their risk position.

Only where such confidence is seriously threatened do we see a rush to buy or sell, a flight to safety, a stampede for liquidity, a run on the bank or other disorderly unwinding of positions that cause the massive disruptions that concern regulators and firms and lead to bubbles and crisis.

It is important to realise that there is no one cause of a loss of confidence and we need to guard against views that link systemic importance simply to size, interconnectedness, complexity, a particular product, or any other single factor. Systemic risk should be determined in line with the financial stability definitions and measured and mitigated using a combination of macro- and micro-prudential tools in an efficient and effective supervisory structure.

There are no hard boundaries between systemic and non-systemic risk. Indeed, different tools are required for different circumstances. The tools that work well in a steady state environment may well be significantly different from those required in crisis, or situations building to crisis. There is therefore a need to continually assess both the objectives and the regulatory tools that are used to influence behaviours. Sound judgement by experienced regulators that considers the issues in the round and with proper coordination at the global level, will be vital.

“Sound judgment by experienced regulators will be vital”
1. Financial stability and systemic risk

The Existing Landscape

The participants in the global financial services industry cover a wide spectrum. They display diversity in legal structure, product capability, size, complexity, interconnectedness, geographical reach, risk profile and corporate governance, to name but a few. The debate on systemic risk seems, however, to have focused on how a higher regulatory threshold should be set for the small population of larger firms, rather than whether individual risks should be measured for all and consistent action taken across the complete population of firms with those particular risks. This is despite the fact that not all failed firms in the crisis were the largest or most complex participants in the industry.

Whilst there is a significant volume of published material on large, complex multinational institutions and how they provide value-added services and significant benefits to the economies in which they operate, there seems to be a considerable risk of these real benefits being disregarded when setting the new regulatory requirements.

Large multi-functional, multi-national institutions can bring benefits such as:

- increasing investment choices by providing access to products from the global marketplace;
- providing the necessary scale for certain types of business, which allows broader product choices and lower costs to consumers;
- facilitating access to finance by allowing global savings and investment flows to government, corporate and individual borrowers that would not otherwise have access to such diverse funding sources;
- encouraging international trade by maintaining and improving the payments infrastructure;
- promulgating and driving good business practices across national boundaries;
- increasing the resilience of the financial system through their capital strength, business models, reputation and brand awareness, which reinforces investor confidence;
- utilising local experience and resources in global businesses and thereby providing growth, employment, education opportunities and infrastructure that would otherwise be difficult to replicate;
- increasing product standardisation and understanding to enable cross-border business to be concluded and risks to be managed more effectively; and
- achieving higher corporate governance standards with improved separation and independence of control and risk functions, and “best in class” systems and management.

“Labelling certain institutions as systemically important will not achieve the improvement in financial stability being sought”

See, for example, IIF “Systemic Risk and Systemically Important Firms: An Integrated Approach”
The diversification that large internationally active firms achieve helps them to absorb local, regional and market shocks and therefore contribute to global financial stability. From a regulatory perspective large internationally active firms also provide access to data that would be more expensive and difficult to obtain in a fragmented global market.

Proposed structural reforms that limit banks by size, scale or function, or require the separation of certain activities by function or legal entity structure, are simplistic, unworkable and will not help achieve the required objectives. Global businesses are required for global markets so it is important that any new measures do not undermine these benefits and that proper account is taken as to how well risks are managed within such institutions.

Interconnectedness

Given the complexity of the financial services industry and the interconnectedness of its participants, there is significant focus on network analysis to understand cause and effect and the appropriate regulatory tools to use for particular issues. The rational response for an individual institution in certain circumstances can create severe macro-prudential risk when replicated by other institutions. Given the speed with which these risks originate and move through the system, the focus on individual institutions needs to be carefully reconsidered. For example, the hoarding of liquidity by individual banks during the crisis caused stresses in the money markets that, in turn, forced asset sales that depressed prices and caused other institutions to be caught in the crisis. Many individual institutions acting in the same way under micro-prudential policy can, in fact, create the greater magnitude macro-prudential risks.

Furthermore, it is vital to ensure that regulatory action does not increase systemic risk by using tools that do not act on all the elements of the identified risk in the same way. In the above example, a regulatory response that prohibits just some institutions from selling assets into such a downward trend (for fear of increasing the scale of the fall) may actually result in increased risk for those institutions and ultimately endanger their survival should those that are not restricted continue to drive asset prices lower.

The authorities’ work on interconnectedness should not be limited to banks – just as important could be the potential threat to financial stability posed by other participants, such as clearing houses, exchanges, large investors, other types of financial institutions or governments.

Systemically Important Financial Institutions

We believe that publicly designating financial institutions as “systemically important” and developing reforms aimed solely at the treatment of such institutions will not meet the authorities’ objective of maintaining financial stability. Indeed, such a list could, paradoxically, produce the very opposite as firms known to be on it may be assumed by customers and counterparties to be “too big to fail”.

However, if there were to be a regulatory definition of SIFI we believe that significant issues would need to be resolved, including:

- Identifying the relevant threshold for reaching such a designation would be difficult to determine. We believe that no one criterion appropriately represents a good proxy for this purpose and that the complexity of systemic risk means that a blend of factors is necessary. These blends are likely to require consistent and continuous recalibration to ensure they match the existing state of the industry – taking into account new products, processes, technologies and other significant risk factors and mitigating controls imposed elsewhere in the regulatory tool kit.
- Any threshold test is unlikely to be sophisticated enough to exactly match the risks upon which the policy objectives are focused. Regulators could therefore focus on institutions that have been caught by the threshold but do not run significant amounts of systemic risk or fail to monitor institutions below the threshold that can contribute to certain significant systemic risks.

1 The Basel Committee on Banking Supervision highlights that there are some significant drawbacks with identifying SIFI. It is “not an easy task” and potentially has associated moral hazard issues. See Consultation Paper: Proposal to ensure the loss absorbency of regulatory capital at the point of non viability - issued August 2010 for Comment by 1 October 2010.
1. Financial stability and systemic risk

- Any threshold, especially where it is complicated to set, will pose difficulty in determining when individual institutions have crossed it. Where particularly severe consequences stem from meeting such thresholds, institutions will be incentivised to meet, maintain or fall below the relevant triggers. Regulators will need to be aware of the possible unintended consequences of such an approach and the possible transfers of risks between institutions, or to the non-regulated sector. These transfers may well create disruptive imbalances or asset flows that make detection of systemic risk more difficult.
- The identification and labelling of particular firms as systemically important will have an impact on moral hazard and the transparency of the obligations associated with such a status may well affect systemic risk, competition and public ratings, while also creating barriers to entry and significantly altering funding costs.
- Any threshold test would need to be consistent and coordinated nationally, regionally and globally.

**Coordinated Micro and Macro Supervision**

The European Supervision package very legitimately addresses this fundamental issue. An optimal environment would feature an effective, coordinated combination of micro- and macro-prudential supervision. The macro-prudential focus on identifying, measuring and mitigating systemic risk, coupled sensibly with micro-prudential assessment of risks at individual institutions and how they are mitigated, should provide a solid foundation for improved financial stability. This top down and bottom up approach has significant policy and practical advantages and will allow risks to be identified and mitigated risk-by-risk, rather than through a focus on just particular types of participant.

We believe that the proper supervision of institutions within such a framework would be a far more effective regulatory tool than any “one size fits all” attempt to classify firms, and that any requirement to subsidiarise, reduce by size or scope, or break up institutions by particular function would be a simplistic, and probably futile, attempt to achieve the same objective.

A holistic approach to systemic risk could ensure that:
- systemic risks that occur or build up outside any particular group of participants are capable of being identified;
- regulators have a more complete view of the risk profile of the system and how this applies to those that they regulate;
- risk mitigation tools are applied only to those participants that can contribute to the specific risks concerned;
- any identified risk is treated in the same way by all institutions that have it, rather than just a specified subset of the population – a point noted and included in the current UK regulatory reform proposals;
- risks are appropriately identified, managed and mitigated by the population exhibiting such risk profile, and those without such risks are not directly affected;
- sound industry practices are promulgated via the supervisory process;
- the moral hazard issues are minimised; and
- recalibration of the systemic risk analysis can be carried out continually and without any associated transparency issues that would apply to moving institutions in or out of a particular category.

**Conclusion**

The latest crisis was global in nature and it is therefore vital that regulatory reform is internationally coordinated and consistently and evenly implemented. Large parts of the financial system, including many large, complex, well-run multinational institutions, continued to function well during the crisis. Equally, some smaller, less complex institutions failed. The benefits of large multinational institutions to the financial system and global economy as a whole should not be underestimated and must be appropriately safeguarded within the reforms designed to maintain and improve financial stability.
The industry understands the urgency with which this work needs to be completed and is keen to ensure it plays its part in promulgating suitable regulatory reform across a wide range of subjects. Any new regulatory structure and associated tools for the achievement of financial stability must not be so conservative as to excessively drag on economic growth and should allow for the possibility of individual institutional failure within a structure that can assess and limit the contagion risk of such failure.

The public labelling of certain institutions as systemically important will not achieve the improvement in financial stability that is being sought. An effective combination of micro- and macro-prudential supervision would provide a holistic overview of risk and give the industry and regulators the best opportunity to deal effectively with systemic risk. This requires firms to have in place robust processes for identifying, assessing and mitigating risk. While risk management requires specialist expertise, responsibility for any corporate entity’s stability rests ultimately with its Board. It is to this responsibility that we turn in the next chapter.

Further reading:

IIF Systemic Risk and Systemically Important Firms- An integrated Approach

Basel Committee on Banking Supervision Consultation Document Proposal to ensure the loss absorbency of regulatory capital at the point of non viability
www.bis.org/publ/bcbs174.htm

IMF Staff Position paper Redesigning the contours of the Future Financial System

Significant regulatory initiatives:

Proposals to strengthen financial supervision in Europe:
Commission adopts legislative proposals to strengthen financial supervision in Europe

Community macro prudential oversight of the financial system and establishing a European Systemic Risk Board

Public Consultation regarding an EU framework for Cross-Border Crisis Management in the Banking Sector

New framework to increase transparency and ensure coordination for short selling and Credit Default Swaps

SIFI Capital Charges:
Group of Governors and Heads of Supervision announces higher global minimum capital standards, 12 September 2010:
http://www.bis.org/press/p100912.htm

ECB
ECB paper: Financial Stability Review
June 2010:
http://www.ecb.int/pub/fsr/shared/pdf/ivcfinancialstabilityreview201006en.pdf?8c6dcc2e95c1bcfd9a36c9db1b5fd8e0

Debate and future outcomes on “Breaking up the Banks” (UK)
Consultation: A new approach to financial regulation: judgment, focus and stability
Consultation page:
http://www.hm-treasury.gov.uk/consult_financial_regulation.htm
Consultation PDF
http://www.hm-treasury.gov.uk/d/consult_financial_regulation_condoc.pdf
Executive summary

• A lack of robust corporate governance processes combined with a lack of Board commitment to developing and overseeing risk management systems have been recognised as contributing factors in the financial crisis.

• The Board must ensure that a comprehensive risk management process is put in place with specified parameters of the firm’s risk appetite and tolerance, and it must oversee the operation of the firm’s risk control processes and culture throughout the firm. It is irrevocably a Board’s responsibility to satisfy its supervisors, and ultimately its shareholders, that appropriate Board governance and risk management policies are in place.

• There is no single governance model that will be appropriate to all firms in all jurisdictions. The Board must determine the appropriate governance measures for a firm after considering its business model and legal/geographical structure.

• There is a need for a coordinated global approach to corporate governance by supervisors to ensure that the differences between global firms and regional-national firms are efficiently recognised in regulation.

• One way to ensure the whole firm is aware of and actively seeking to minimise systemic risk is to link remuneration to compliance and risk management objectives.

Sound corporate governance practices are the key to effective risk management. Hence it is no surprise that this aspect of financial institutions’ management has come under considerable scrutiny since the crisis.

It does appear that, in the recent past, the Boards of some banks showed a lack of commitment to the important responsibility of setting risk tolerances or appetites. In some cases, they have failed to ensure the establishment of independent and competent risk management structures and processes capable of identifying, measuring and controlling risks, or to oversee results.

The parameters of a firm’s risk appetite and tolerance must be established with the consent of the whole Board. The process by which the risks that fall within the scope of those parameters are independently identified, assessed, and controlled may be delegated, provided that there is sufficient independence from business leadership to allow appropriate challenge.

An important point to note here is that delegation does not permit abrogation of responsibility. Boards must charge themselves with the ultimate responsibility to...

“The Board must ensure that its own culture encourages independent challenge on risk issues”

1 AFME has considered and responded to the consultations issued by Sir David Walker and the Financial Services Authority (FSA); the proposals from the Basel Committee on Banking Supervision (BCBS) and, more recently, the EU Green Paper on Corporate Governance. All of these responses are available on our website (www.afme.eu).
understand the important risk aspects of all of the firm’s businesses and ensure that the firm has the personnel and technical resources in place to manage risk appropriately. The Board must ensure that its own culture encourages independent challenge on risk issues, which is not susceptible to being overreached at Board level by very strong business leadership.

In this respect a Board should institutionalise its culture of independence through its own governance structure, processes and selection of directors. It must be capable of overseeing the enterprise as a whole, through oversight of the proposals and actions of senior executive management.

We note that there are numerous possible approaches to establishing an effective risk management process. One option is that the Board establish a Board-level Risk Committee, chaired by an independent director, to perform the risk function and advise the Board. Another is that a firm appoints a Chief Risk Officer (CRO) with access and accountability to the Board’s Risk Committee and the full Board. This person would be empowered to assess financial risk issues independently of the executive team and to oversee the risk management structure throughout the enterprise. Both approaches are sound but they are not the only credible options and may not be appropriate for some financial firms.

We do not believe that any specific model should be mandated for all financial firms because one model cannot be appropriate for every firm. The implementation of governance principles should be proportionate to the size, complexity, structure, economic significance and risk profile of the bank and the group (if any) to which it belongs. These differences may require different approaches, which could include:

- oversight by the board;
- oversight by senior management;
- direct line supervision of different business areas;
- independent risk management, compliance and audit functions; or
- any combination of these approaches.

Since there are so many important variables it would be a difficult task to set out a comprehensive governance path for international finance groups, or to define an appropriate governance methodology between a parent company and its subsidiaries. No one paradigm would fit all international groups or all parent-subsidiary structures. We advocate that each Board should continue to have the responsibility to determine what governance measures are appropriate for a firm after considering its business model and legal/geographical structure. Some particular points to bear in mind are:

- the extent to which governance principles should be implemented by a particular subsidiary should be for the Board of that entity to decide, subject to review by its supervisor;
- since subsidiaries typically will benefit from the corporate governance structures applied at the parent level and the oversight of group employees, there should be no presumption or requirement that a subsidiary should replicate exactly the same structure as its parent;
- the benefits of ensuring harmonised standards, and achieving a global view of risks, point to the use of firm-wide committees (with appropriate regional and entity representation) rather than establishing equivalent committees for each relevant entity;
- there may be cases, however, where it will make sense to have entity specific committees operating in coordination with equivalent firm-wide committees. For example, banks with firm-wide audit or risk committees may also choose to establish one or more entity-specific committees to ensure detailed focus on the specific risks carried in the group’s major subsidiaries; and
- generally, there is a reduced need to have non-executive directors or independent members on the boards of subsidiaries or on their committees.
Global Regulatory Framework

More generally, we endorse the view of the Basel Committee on Banking Supervision that there is no need to establish a new regulatory framework to be layered on top of existing national legislation, regulation or codes. As long as several essential functions are in place, sound governance can be achieved regardless of the form used by a banking organisation.

Crucially, it will be necessary for the bank regulators in each country to carry forward this perspective when implementing principles and policies within the context of their local legal and regulatory frameworks. In our view it is critical that a prescriptive regime not be promulgated by supervisors or governments. In a unitary Board, the Board is responsible as a whole and must determine how to govern itself and the optimal method of managing and controlling risk.

The Role of Senior Executive Management

Generally, the executive role of senior management must be distinguished from the oversight role of the Board when:

- setting and enforcing lines of responsibility and accountability throughout the organisation;
- ensuring the regular review of policies, processes and the control functions; and
- differentiating the Board’s responsibility to ensure that the control functions are set up to operate independently and efficiently.

The Board should satisfy itself through its dealings with senior management (and others if deemed necessary) that the control functions, policies and procedures of the firm are robust, appropriate and proportionate.

Remuneration Policy

In the immediate aftermath of the financial crisis, AFME members acknowledged that more needed to be done to align incentives with proper risk management and worked to design remuneration structures that complement the control and risk management functions. Even before the G-20 endorsed the FSB Principles and the related Implementation Standards, AFME members had already implemented – and frequently exceeded – the core provisions. A comprehensive description of the changes that have taken place is beyond the scope of this paper, but includes:

- allocation of remuneration between fixed and variable pay has been re-examined and recalibrated;
- the amount of variable pay is now determined by reference to a broader range of metrics (including compliance and risk adjustment) assessed over a longer period;
- a larger proportion of variable remuneration is now paid in equity;
- variable pay is now deferred to reflect the long-term risk profile of the individual business unit and institutions;
- guaranteed bonuses are offered only in exceptional circumstances; and
- variable compensation can now be clawed back for underperformance or malfeasance.

Even as the structure of remuneration changes (and the absolute amount reduces), it is vital to recognise that the financial services industry operates in a global and competitive environment so international coordination is critical. Banks rely on human capital to put financial capital to work productively and efficiently. Talent is limited and competition fierce. Only an appropriate degree of flexibility will ensure that the labour market functions properly.

Equally important is that ultimate responsibility for the structure and oversight of remuneration be vested unambiguously with the Board (assuming that the enhanced governance safeguards and remuneration policies discussed in this chapter are in place). Shareholders have a valuable role to play in signalling their views directly on particular matters, but only directors can closely coordinate the alignment of remuneration policies with the overall risk profile and strategic direction of an individual firm.


**Directors’ Responsibilities/Liabilities**

It has been suggested that the potential liabilities of directors in general, or of non-executive directors in particular, be increased. We consider that such a move would be counterproductive and unfair. Parent bank Boards are generally oversight bodies that are not charged with managing the daily activities of the company. Corporate governance codes should reflect this oversight role. For example, in a complex financial institution, there will be many subsidiaries and it is impractical for a Board to have extensive awareness of the details of individual entities. Applicable laws and regulations should explicitly recognise the concepts of materiality and reasonableness, policy review, and the ability to delegate when dealing with Boards’ and directors’ responsibilities. Nevertheless, it is irrevocably the Board’s responsibility to satisfy its supervisors, and ultimately its shareholders, that appropriate Board governance and risk management policies are in place.

This paper does not specifically address the relationship between a Board and its shareholders, although we do believe that the chair of the Board risk committee (or its equivalent) should be available to take questions at the AGM and a report from the committee should be filed with the annual return. Shareholder involvement with financial institutions is, in practice, a mechanism for limited control of risk management. The relationship with supervisors is, on the other hand, central to this function and is considered in the next chapter.

**Further reading:**

OECD Principles of Corporate Governance (as revised 2004)  

Sir David Walker: A Review of Corporate Governance in UK Banks and Other Financial Industry Entities  

Basel Committee on Banking Supervision: Principles for Enhancing Corporate Governance (Consultative Document)  
http://www.bis.org/publ/bcbs168.pdf

EU Commission: Green Paper on Corporate Governance in Financial Institutions and Remuneration  

http://www.cfr.org/project/1404/squam_lake-working-group-on-financial-regulation.html

IIF (in cooperation with Oliver Wyman, Compensation Reform in Wholesale Banking 2010: Progress in Implementing Global Standards (September 3, 2010))  

**Significant regulatory initiatives:**

CRD III provisions relating to remuneration, parliamentary press release:  

FSA CP 10/19 Revising the Remuneration Code (proposals to implement CRD III in the UK):  

EU Green Paper on Corporate Governance:  

FSA/FRC DP 10/3 Enhancing the Auditor’s Contribution to Prudential Regulation:  
http://www.fsa.gov.uk/pubs/discussion/dp10_03.pdf

FSA CP 10/3 Effective Corporate Governance (Significant Influence Functions and the Walker Review):  
http://www.fsa.gov.uk/pubs/cp/cp10_03.pdf
Executive summary

- At the centre of the Basel 3 reforms (first proposed in December 2009) is a need to create a more resilient banking system. The measures being contemplated are multiple and complex but, broadly, aim to: increase the quality of capital being held by banks; enhance the coverage of risks against which capital is held; address the issue of leverage; reduce procyclicality; address the interconnectedness of firms; and introduce an international liquidity framework.

- In the context of systemic risk, the Basel 3 measures of particular interest are the introduction of multiple regulatory buffers and contemplation of capital or liquidity surcharges for firms designated as SIFI.

- In our view a SIFI surcharge would represent just another regulatory buffer (albeit one that attempts to reflect how systemic risk crystallises in firms). Not unlike the Basel Committee, we consider capital instruments performing a similar function to a SIFI surcharge to include going and gone concern contingent capital.

- Any assessment of how systemic risk builds up in firms is better addressed by the enhanced supervision of firms: a closer working relationships between firms and regulators (that formalises and consolidates good supervisory practices that have evolved under what is known as Pillar 2 under the Basel 2 framework) and a supervisory mandate that enables supervisors to intervene and mitigate risks locally before they spread into the wider financial system.

The financial crisis has understandably led to an increased focus on firms’ capital and liquidity resources as well as their ability to identify early warning signs and cope with future stress. As a result, prudential regulation is being reviewed and reformed. While some countries have introduced local changes and we have seen amendments to the European Capital Requirement Directive (CRD), the changes being proposed to the Basel 2 Capital Accord (2005) are wide ranging and have been instigated by the G-20. AFME and its members, through the Global Financial Markets Association (GFMA), have made extensive contributions to the discussion about the changes needed to the current rules.

Basel 3 Reforms

In December 2009 the Basel Committee published a package of reforms (BCBS 164: Strengthening of the resilience of the banking system and BCBS 165: International framework for liquidity risk measurement, standards and monitoring). In parallel the European Commission issued its own consultation (Possible further changes to the capital requirements, otherwise known as CRD 4). In broad terms, the proposals aim to:
• improve the quality, consistency and transparency of the bank capital base;
• strengthen the risk coverage of the framework with new standards for counterparty credit risk exposures arising from derivatives, repos and securities;
• introduce a leverage ratio with the purpose of containing the build up of excessive leverage in the banking system and providing an extra layer of protection against model risk and measurement error;
• improve measures to address procyclicality; and
• introduce two minimum liquidity risk standards – a 30-day liquidity coverage ratio (LCR) and a 1-year Net Stable Funding Ratio (NSFR) – along with a set of common monitoring metrics and application standards to allow supervisors to analyse liquidity risk trends at a bank and system wide level.

Some of the measures being contemplated by Basel 3 are complex and need to be considered in terms of their cumulative economic impact and interaction with other measures. As a consequence, we are now seeing transitioning arrangements being put in place for both the leverage ratio and NSFR and the Committee may consider other areas where such arrangements are needed. The financial services industry also remains concerned about the calibration of the package and the numerous technical points to be resolved, but, nonetheless, it shares the objective of achieving a robust, proportionate and more risk sensitive capital requirements regime.

In the context of systemic risk, the Basel 3 measures of particular interest are the introduction of multiple regulatory buffers, the contemplation of a capital and/or liquidity surcharge for firms designated as SIFI and the potential role that contingent capital (which we presume to include both going and gone concern) could play in mitigating such surcharges.

We do not believe that there is a need for a capital or liquidity surcharge on SIFI. Indeed, as we explain in Chapter 1, there are major issues with proceeding to have special rules for institutions deemed to “systematically important”. It is our view that a SIFI surcharge represents just another regulatory buffer (albeit one that attempts to reflect how systemic risk crystallises in a firm). We suggest that capital instruments performing a similar function to a SIFI surcharge include contingent capital (which we presume to include both going and gone concern).

We also suggest that crystallisation of systemic risk within a firm is best addressed through the supervisory tools already available to the regulatory community, as we explain overleaf.

“Enhanced supervision will introduce a continuous dialogue between a firm and its supervisors”
Effective prudential regulation is not achieved merely through capital and liquidity requirements. Whilst the principle that firms govern and take responsibility for themselves must be preserved, it is accepted that supervisory activity over firms’ behaviour and resources has to become more effective to ensure that risks are better understood by regulators and that preventative measures taken as part of the Pillar 2 approach (in its broadest terms) are timely.

We recommend a holistic approach, which we describe as “enhanced supervision”, as the way to ensure that emerging risks can be identified early and satisfactorily addressed. The framework we propose (which is explained in detail in Annex 1 to this paper) must:

• be capable of making the link between the activities and risks of the individual firm and the risks to the wider financial system;
• be grounded in a deep understanding of the supervised firms’ business models, and the risks inherent therein;
• be sufficiently flexible and risk-based, to ensure that capital and supervisory resources are targeted appropriately;
• be sufficiently responsive, continuous and consistently applied so that emerging risks are identified and tackled at an early stage;
• ensure that supervisors have the appropriate powers and resources; and
• include appropriate safeguards on supervisory action to avoid diminishing returns of poorly targeted supervisory requests, unjustified supervisory action, or, equally problematic, supervisory inaction.

Enhanced supervision will be best judged by reference to five targeted outcomes:

1. Supervisory expectations are transparent and benchmarked to reflect a firm’s peers and the markets in which it operates.
2. Assessment of governance and culture forms an integral part of establishing the risk profile of any firm.
3. Clear linkage is demonstrated between qualitative and quantitative approaches to supervision.
4. Timely and targeted supervisory interventions avoid a “one size fits all” approach.
5. Market confidence increases as a consequence of enhanced supervisory oversight.

Collectively, these outcomes should result in confidence in the prudential soundness of the firm. In turn, this should promote mutual trust, prevent arbitrary regulatory actions and counter the assumption that a surcharge applied across a SIFI class, above the revised general Basel standards, is the only (or even a superior) supervisory response to a risk emerging within a firm.

The recent crisis has already brought about considerable changes to supervisory practice, including more intensive supervision in many countries. There has also been a significant and targeted increase in the level of capital and liquid funds held by firms, coupled with better risk management and contingency planning (including work on the introduction of formal recovery and resolution planning).

The need for better and more effective oversight and supervision is also being addressed by the G-20. The Toronto Communiqué highlighted that new and stronger rules need to be complemented with more effective supervision and oversight. The G-20 has asked the Financial Stability Board, in consultation with the International Monetary Fund, to develop recommendations to strengthen oversight and supervision, specifically relating to the mandate, capacity and resourcing of supervisors and the specific powers, including early intervention, which should be adopted proactively to identify and address risks.

To some extent, enhanced supervision represents the formalisation and consolidation of good supervisory practices that have evolved over time, and reflects what is known as Pillar 2 (in its broadest sense) under the Basel 2 framework, and been given impetus by the recent crisis. Inevitably, enhanced supervision will introduce further changes in the style of supervision,
with a more continuous dialogue between a firm and its supervisors and less reliance on “big bang” reviews occurring periodically. Furthermore, the internal processes within the regulator should be transparent and flexible enough to accommodate that breadth of dialogue.

Enhanced supervision also requires that supervisors be provided with a mandate to act and have the skills and resources to undertake this form of supervision. Although a challenge for regulators to meet, it is essential that supervisory teams have the necessary mix of skills and aptitudes not only to understand firms’ businesses and identify risks therein but also to challenge firms appropriately. There must also be safeguards on supervisory action. These are discussed in detail in Annex 1.

It follows from this, and from the arguments against the formal classification of firms as being “systemically important” set out in chapter 1, that imposing general capital surcharges on firms considered to pose a systemic risk – as has been suggested – would be a mistake. The key arguments against surcharges are that they are less able to be adapted to emerging risks and do not help to ensure that the right amount of capital is held in the right places in the financial system as a whole. Moreover, before any further quantitative measures are imposed, due consideration needs to be given to the impact of the changes being introduced via the Basel 3 reforms and the calibration of the package.

We believe that the combination of better risk management and contingency planning in firms along with enhanced supervision as described above would mitigate the risk of future crises much more effectively and proactively than the blanket application of capital, above the revised general Basel standards, which merely provides false comfort – because it is insensitive to changes in risk brought about by market developments – and systemic risk may be better addressed through enhanced supervision building on the current Pillar 2.

**Further reading:**

- G-20 Pittsburgh Summit statement, September 2009
  [http://www.g20.org/Documents/pittsburgh_summit_leaders_statement_250909.pdf](http://www.g20.org/Documents/pittsburgh_summit_leaders_statement_250909.pdf)
- G-20 Toronto Summit declaration, June 2010
  [http://www.g20.org/Documents/g20_declaration_en.pdf](http://www.g20.org/Documents/g20_declaration_en.pdf)
- Joint industry response position paper to the Basel Committee’s December 2009 Package:
- Joint industry response position paper to the Commission’s February 2010 proposal:
- AFME’s Summary Position on the Basel Committee’s December 2009 Package and CRD4, June 2010.

**Significant regulatory initiatives:**

- Consultative proposals to strengthen the resilience of the banking sector announced by the Basel Committee, 17 December 2009
  [http://www.bis.org/press/p091217.htm](http://www.bis.org/press/p091217.htm)
- 18 June 2010 Press Release - Adjustments to the Basel II market risk framework announced by the Basel Committee
  [www.bis.org/press/p100618.htm](http://www.bis.org/press/p100618.htm)
  [www.bis.org/press/p100716.htm](http://www.bis.org/press/p100716.htm)
- 26 July 2010 Press Release - The Group of Governors and Heads of Supervision reach broad agreement on Basel Committee capital and liquidity reform package
  [www.bis.org/press/p100726.htm](http://www.bis.org/press/p100726.htm)
- Annex to 26 July 2010 Press Release – Broad agreement on main elements of the design of Basel 3 as announced by The Group of Governors and Heads of Supervision
- Group of Governors and Heads of Supervision announces higher global minimum capital standards, 12 September 2010
  [http://www.bis.org/press/p100912.htm](http://www.bis.org/press/p100912.htm)
Executive summary:

- In regulating markets to reduce systemic risk, considering the specifics of each sector and applying regulation accordingly is preferable to taking a “one size fits all” approach. This way, market efficiency and systemic risk reduction go hand-in-hand.

- This is true for movements towards organised trading platforms, product standardisation and CCP clearing of OTC products. It also goes for the imposition of pre- or post-trade price transparency. Similarly, regulation of short selling, because of the uncertain benefits for systemic risk reduction, should be implemented with caution.

- We favour the establishment of one global Trade Repository per asset class and full, immediate and coordinated transaction reporting to regulators to enable effective supervision. We caution against public transparency on the basis of its negative impact on liquidity and ultimately risk management.

- The Giovannini Barriers to cross-border post-trade processing of securities are a source of potentially systemic risks. While the industry has made good progress on many of the Barriers, the completion of this process will in most cases require public sector action.

- We welcome closer dialogue between regulatory bodies, policy makers and market participants. It is critical that market changes do not inadvertently introduce new risks into the system as a result of disjointed and counter-acting processes.

Market crises in recent years, whether from the credit crunch, general liquidity crisis, bank failures, or recent sovereign crisis, have led policy makers to consider how to address these market failures. Market reform, where appropriate, is welcome and AFME members support efficiency improvements in trading processes to restore confidence in the markets and reduce systemic risks.

The systemic risk profiles of Europe’s capital markets are to a significant extent determined by the structures and processes underlying them. The key elements include: the venues in which trading is carried out; the reporting and settlement of trades and the degree to which information is made public; the ability of regulators to have access to the data they need in order to monitor markets effectively while maintaining market participants’ confidentiality; and the degree to which products and processes can be standardised while still allowing for innovation.

“A ‘one size fits all’ approach may have a counterproductive effect on systemic risk”
Many of the recent developments in the trading, reporting and post trade processing of financial instruments have had a positive impact on systemic risk reduction and management. For example, some standardisation of processes and centralisation of clearing and reporting have been beneficial. However, there is a risk that if a “one size fits all” approach were applied to many aspects of this diverse market there may be a counterproductive effect on systemic risk. In this chapter, we set out our views on the existing reform proposals, both regulatory and market-led, note the areas in need of most urgent attention and offer suggestions that the authorities may wish to consider as they take their work forward.

Short Selling

The short selling of financial instruments is often cited by non-market participants as a cause of market instability and, therefore, risk. This is not the case. Short selling is a well-established trading activity, essential for market making and widely accepted by investors and regulators (e.g. IOSCO and CESR) as helping to enhance price discovery, counteract supply/demand imbalances and provide liquidity to the market in the relevant securities.

AFME is not aware of any evidence that demonstrates short selling contributing to systemic risks. Furthermore, observers such as the International Monetary Fund suggest that most of the adverse market movement in the recent crisis can be attributed to fundamental factors. The IMF sees short selling as “a symptom and not a cause of the problem”. It notes that short selling “can help mitigate market bubbles”. In this sense it could help reduce systemic risk, rather than cause it.

Private reporting to regulators will enable them to monitor adverse or market abuse behaviours, distinct from normal trading activities. Public disclosure of individual firms’ short positions would, however, be disproportionate and could be harmful. For equities, as an aide to greater market transparency, regulators may wish to consider publishing aggregated privately notified short positions.

Some fear the market will be disrupted by transactions where the seller has little or no intention of covering the sale and have argued that a blanket ban on uncovered short selling would mitigate this. This would be a disproportionate response to the small risk of non-settlement, and would negatively affect other selling and securities lending activity. Uncovered short selling can, in fact, have important benefits for the market as a whole, in terms of liquidity and investor confidence. The most appropriate way to discourage abusive uncovered short sales would be through the application of reasonable and consistently applied settlement discipline measures such as buy-ins, which would apply to any persistent settlement failure.

Regulators, on occasions, deployed emergency powers to halt short selling in specific instruments. It is right that these powers should be available so that regulators may intervene to restore order and confidence in emergency situations. However, banning short selling in difficult market circumstances can increase stress and volatility and may actually serve to undermine confidence. Care is therefore needed when defining the circumstances in which emergency powers may be used.

Price Transparency

Deep, liquid and transparent markets are important criteria for effective risk management as they enable participants to access the capital markets for funding, hedging risks, and increasing or unwinding their positions with relative ease. A core element of the review of the Markets in Financial Instruments Directive (MiFID) is to improve the market further by increasing the availability of pricing information to market participants. AFME supports this. In our view, the optimal regulatory approach would take into account the following three key aspects when considering price transparency:

- promoting a thriving market place that enables wide participation and brings real benefit to the European economy;
- encouraging greater education and transparency for smaller institutions
4. Market Infrastructure

without punitive impact on the wholesale marketplace; and

- **calibrating the balance** between protecting liquidity for market participants whilst also ensuring adequate transparency.

Any measures aimed at improving pre- and post-trade price transparency need to carefully counterbalance the impact these measures may have on dealers’ ability to commit capital and ultimately to provide liquidity. This is particularly crucial in times of stress when market liquidity plays such an important role. Without liquidity, participants’ ability to manage their positions is severely impaired, which will further exacerbate risks in the system.

The financial market comprises a number of very different asset classes and, as such, pre- and post-trade transparency requirements need to be appropriately calibrated to take account of these differences. Each instrument has its own distinct set of characteristics and, within it, varying levels of liquidity. The transparency regime for each should take into account:

- **Comparability of the instruments** – understanding the difference between standardised versus more complicated bespoke transactions. This is crucial in order to ensure price data provided is not misleading and enables users to compare “apples with apples”.

- **Liquidity of the instrument** – a number of factors impact the liquidity of an instrument, such as:
  - initial size of deal;
  - trading volumes for the transaction;
  - size outstanding;
  - and whether instruments are on or off-the-run, especially in terms of contributing to a price-yield curve. Reporting liquid and illiquid transactions with the same measure will only reduce interest in the illiquid transactions, exacerbating the problem further.

- **Complexity of the instrument** – these are factors that affect how quickly disclosure should be given to the market participants “outside” of a trade without punitive impact on those “in” the trade. Such factors include: complex pricing structures; bespoke or large transactions; the number of dealers customarily active in the instrument; and the time required to execute, hedge or unwind positions. All require suitably protective delays of, at a minimum, settlement period before disclosure to wider market participants.

Overall, transparency is to be welcomed where it benefits market users and comes at a cost proportionate to the benefits. Publishing data that is not used will cost the industry and, ultimately, the end user. Any additional dissemination of information should not add complexity and confusion for its users.

With little direct retail involvement in many asset classes, any measures to be proposed should take account of the overwhelmingly wholesale nature of these markets. Otherwise, liquidity (and risk management) could be damaged in an attempt to serve a class of participant that is not an active user of the product.

Finally, any new regime should consider the fluid nature of the market and begin with a phased approach to enable regulators and market participants to assess fully the benefits and impacts of each phase on the market place. Inadequate testing or review will introduce unintended costs and new risks to market participants.

A regime that fails to consider these factors (at a minimum) will fall short of the intention to promote a thriving market place, improve transparency to new or smaller market participants and protect liquidity in the market.

**Trading Venues**

In recent years the market has continued to see a growth in organised trading venues or “platform trading”, where specific instruments are traded automatically using technology that matches prospective buyers and sellers. The appeal of such platforms is that they are perceived as offering improved transparency, price formation, liquidity, operational efficiency and market access.

However, while the centralisation of trading may in certain circumstances facilitate transparency, liquidity and risk mitigation, this is not universally the case and, irrespective of the nature of the instruments traded or the parties trading them, the growth in platform trading may lead to an overall increase...
in systemic risk. The decision as to whether trading should be multilateral or remain bilateral is, therefore, not as clear-cut as it may seem and requires consideration of a number of factors.

Benefits cannot be attained through platform trading where there is insufficient liquidity or participation in a particular product to support effective platform trading. In many cases, bilateral trading, whether over-the-counter (OTC) or on bilateral trading venues, will remain an important method of negotiating trades, especially block trades.

There is a wide range of execution models for platform trading on offer, including single dealer platforms, multidealer platforms, inter-dealer brokers and exchanges. Some offer combinations of electronic services or traditional voice methods. We see all of these as complementary, attracting different users according to their requirements, and would be concerned to see all trading move to the exchange trading model. The nature of the liquidity and the type of market participation is critical in determining whether this centralised model of execution will be effective for a typically bespoke market such as derivatives. We believe, therefore, that allowing each market to select the most appropriate mode of execution would produce the best outcome.

While standardisation is a pre-condition for multilateral exchange trading, it is even more important that there is continuous liquidity and a number of participants with matching trading interests, enabling those interests to be matched without the need for an intermediary. The bond markets (which are characterised by a high degree of over-the-counter trading) illustrate that highly standardised instruments are not a sufficient criterion to ensure trading on exchanges. In cases where there is a relatively small number of professional market participants with different risk and investment requirements, there is likely to be a natural timing gap between the emergence of natural buyers and sellers, which makes the market less likely to gravitate towards exchange trading.

If multilateral exchange trading is mandated for markets that are naturally better suited to OTC trading, liquidity will, in fact, be discouraged. Intermediaries will no longer have the information obtained through market making that encourages them to supply liquidity and the reduction in the ability to manage risk will have consequential impact on the costs and competitiveness of end users of the markets, such as corporates.

In addition, platform trading can see order and transactions sizes decrease while the frequency of trades increases. However, these trends can also be signs of an inefficient market, as they can be the result of the unwillingness of market participants to perform effective risk transfer functions. Markets characterised by those features can also be more vulnerable to risks of the kind illustrated by the May 2010 “flash crash” in the US.

It is important to allow continued scope for innovation through the creation of new products and services. Even where products are traded on organised trading platforms, it must still be possible to trade them on an OTC basis. Many products, including equities, are traded both OTC and on exchange. For example, large blocks of shares are currently traded OTC for a number of reasons, such as confidentiality, inability of exchanges to process large stakes, etc. There would be no advantage in confining this kind of trading to an exchange, even though shares are completely standardised and completely fungible. Similar issues arise in relation to derivatives, where large institutional participants frequently trade in large sizes to hedge or manage risks. These trades are an essential feature of the market but cannot be handled through platform trading.

**OTC Standardisation**

While the standardisation of financial instruments can facilitate improved risk management, certain risks can be properly managed only through bespoke products.

Legal process and product standardisation can have significant benefits for minimising systemic risk. It can, among other things:
• reduce operational risk by automating processes, which can also reduce cost;
• facilitate bilateral and multilateral netting (reducing risks) and the transfer of risk to a central counterparty;
• facilitate the use of electronic trading that improves price discovery;
• improve the ease of unwind as fungible products can be used to perfectly offset or value the acquired risk;
• facilitate the reporting of information for regulatory purposes (which is discussed more below under transaction reporting and trade repositories); and
• enhance contractual certainty, which is helpful in times of disputes between counter-parties.

When considering standardising OTC products, there are some important factors to bear in mind relating to the use of such products to hedge risk. These include:

• the legitimate need for bespoke products to hedge risks by, for example, needing to access variable rather than standard transaction sizes;
• the need to perfectly hedge risk where standardised products would expose the participant to basis risk;
• the imperfect match between the underlying and the hedge position will lead to the loss of hedge accounting treatment under applicable International Accounting Standards rules; and
• the need for a sufficient degree of product maturation in order to support drives towards greater standardisation. Therefore, we need to consider three elements in relation to standardisation:

Legal uniformity: The industry strongly supports a move toward greater legal uniformity of derivatives documentation. Although there are strong incentives for the continued development of standard transaction documentation and definitions, there are also many circumstances in which it may be both preferable and legitimate to use non-standard documentation, so this should not be prohibited.

Process standardisation: The moves to achieve greater process standardisation, including the greater use of electronic trade confirmations, should continue. Industry-agreed progressive targets play a very useful role in this regard. However, there is no case for requiring firms to use electronic trade confirmation services. The industry initiatives towards greater use of such confirmations have generated, and will continue to generate, very significant benefits, even if they do not achieve 100% coverage of all transactions. Mandating their use could well stifle the development of new products and services.

Product standardisation: Further product standardisation should be developed where it is driven by market needs and priorities, and takes into account product maturity, liquidity and customer requirements. Products do not need to be standardised to be liquid, as the market for foreign exchange (FX) products demonstrates.

There are limits to standardisation and firms should retain the flexibility to customise products. This applies as much to financial firms as to their clients. All market participants may need to create customised products and transactions for particular purposes, e.g. to pass risk between group companies. Requiring end users to adopt products that result in mis-matched exposures may well lead them to treat hedging as a source of profit rather than a risk management activity.

Trade Repositories
Regulators should have full access to trading information and Trading Repositories (TRs) provide a vital service in maintaining data on transactions. TRs can provide supervisors with various trade data, including client names, to enable them to develop a more complete view of OTC derivatives market activity and so enhance their ability to oversee the market and its participants. This is important in assessing risks by analysing the distribution of counterparty and market exposure across participants and aiding the timely detection of concentrated positions by any one participant or “crowded” positions in any one type of trade.

Their establishment should be encouraged, particularly in the case of derivatives, but to be most
AFME / PREVENTION AND CURE: SECURING FINANCIAL STABILITY AFTER THE CRISIS

effective, and to provide the required visibility, we favour the development of only one global TR for each asset class. The development of separate regional TRs could be damaging and counterproductive; the fragmentation of information that could arise could increase operational costs. More importantly, it would add to the risk of duplicative or omitted reporting of transaction information.

TRs support a global market and their operations should be structured to support a global supervisory community that is as internationally co-ordinated as possible. The role of TRs in systemic oversight makes it essential not only that they are operationally robust but also that there is no fragmentation of this function, since that would defeat the object of ensuring efficient aggregation of information by asset class. Fragmentation would also impose unnecessary cost and operational complexity and risk.

Where TRs exist, the issue of confidentiality – particularly of proprietary and customer data – is extremely important. Market participants’ support of particular TRs will be largely down to trust that their positions will be kept confidential. Breaches would severely undermine a market participant’s business and put it at a serious disadvantage to its competitors.

The laws relating to client confidentiality may differ from country to country and, at various levels, restrict the ability of banks and dealers to disclose confidential information to third parties. Global coordination on this point would be beneficial.

Transaction Reporting

Full, immediate and coordinated transaction reporting to regulators will enable effective supervision but public transparency will have a negative impact on liquidity and ultimately risk management.

Hence, while public transparency may not be desirable in many instances, full and immediate transparency to respective regulators, across all asset classes and jurisdictions, should be encouraged. The existing daily transaction reporting process in Europe is well-established and effective (although there is scope for discussion on the extension of the reporting obligations for some non-cleared OTC transactions). Daily transaction reporting is important for regulators as a means of monitoring market behaviour and identifying attempts at manipulation, although the current Transaction Reporting Exchange Mechanism (TREM) is not sufficient for the monitoring of positions for systemic risk purposes. Nor are the current trade repositories generally sufficient to handle daily transaction reporting as they generally report on a monthly basis.

A global reporting infrastructure would ensure regulators have a consolidated view of transaction reporting. Duplication of reporting requirements and processes could be avoided. Reviewing the options for reporting infrastructure and implementation would also provide an opportunity for client confidentiality issues to be addressed.

OTC Clearing of Derivatives

The role of central clearing in OTC derivatives has been developing rapidly, having been initially applied to interest rate swaps in the late 1990s and subsequently to credit default swaps (CDS), as that market grew sufficiently large to support it. In such large, liquid markets, Central Counterparties (CCPs) offer an alternative way of managing “interconnectedness”, by means of risk mutualisation, and incremental efficiencies in exposure reduction through multilateral rather than bilateral netting.

However, the use of CCPs is generally not appropriate for bespoke and illiquid products. And for some asset classes, such as FX, it is debatable whether the costs outweigh the benefits, as settlement of these instruments is already efficient and safe. Indeed, the role of robust bilateral clearing as a means of reducing risk should not be overlooked.

In product areas where central clearing may be appropriate, the delivery of risk management benefits will depend on the relevant CCPs being properly capitalised and well-run institutions, as the market would be effectively
taking on risk that is currently distributed amongst the participants and concentrating it in one entity.

In addition, OTC clearing must reflect the global nature of many of the products concerned. Where products from one region are cleared in another, CCPs must give full, equal access and transparency of information to all regulators as required. Otherwise, we run the risk of creating regional clearing models that will split liquidity, drive up costs and make it difficult, or even impossible, for regulators to capture a complete view of the market for systemic risk purposes.

Post Trade Securities Processing
In 1996, the European Commission brought together a group of financial market experts to identify inefficiencies in EU financial markets and to propose practical ways to improve market integration. These experts, the “Giovannini Group”, identified 15 specific obstacles, dubbed the Giovannini Barriers, to efficient EU cross-border clearing and settlement.

The Giovannini Barriers to cross-border post-trade processing of securities are a source of potentially systemic risks. While the industry has made good progress on many of the Barriers, the completion of this process will in most cases require public sector action.

To meet its longstanding commitment to a low risk, integrated and efficient post-trade securities environment for Europe, the industry continues to play a very active role in dismantling the Barriers. For example, it has developed, and is implementing, a comprehensive body of European market standards in the complex and high risk area of corporate action processing and is taking a leading role in joint work with the EC on a common securities settlement cycle for Europe. Substantive input and support has been provided to the public sector’s efforts to remove the Barriers for which it is responsible, including those relating to differences in the legal and fiscal approach of Member States to securities processing.

It is therefore essential that the process of dismantling the Giovannini Barriers is completed. This will mitigate systemic risks originating from or being exacerbated by a fragmented post-trade securities environment. We hope that, as they move forward with their work on market reform, public policy makers will also refocus on the Barriers for which they are responsible and provide vigorous support to market-led initiatives for their removal.

Conclusion
In summary, there are a number of initiatives underway which will continue to strengthen the markets and reduce systemic risk. Industry and regulators should continue to work together to achieve these goals. In this context, it is important to carefully consider each market sector in its own merit, as a tendency towards oversimplification of products and processes may ultimately undermine the mitigation of systemic risks.

Global TRs for each asset class are good tools for regulators to identify where systemic risk is building up in the system. Transaction reporting, while not generally a tool for managing systemic risk, provides regulators with the means to monitor markets and their participants. We favour measured increases in price transparency but not at the detriment of liquidity as that undermines the ability of participants to manage risk.

Standardisation of OTC products is a laudable goal as long as it does not
prevent participants from using bespoke products to hedge their legitimate risk. The clearing of OTC products is a positive development in managing risk for most standardised products provided the benefits are greater than the costs. This, however, does not necessarily mean that these products need to be put on an exchange.

Because of the lack of clear evidence that short selling contributes to systemic risks, we should ensure that this established market practice continues to function in an orderly manner. Emergency powers should be in place but used with great care. Finally, the long overdue removal of barriers to cross-border securities processing would help address potentially systemic risks and material inefficiencies and, in doing so, facilitate a single European securities market.

Further reading:
ICMA European Repo Council/ A white paper on the operation of the European repo market, the role of short-selling, the problem of settlement failures and the need for reform of the market infrastructure/ July 2010/ www.icmagroup.org/ICMAGroup/files/ac/ac9739eb-6c8b-4d0f-9f5c-d0f13e89bd8e.pdf

ISLA paper on short selling and securities lending, July 2010/ http://www.isla.co.uk/uploadedFiles/Member_Area/General_Library/SEURITIES%20LENDING%20AND%20SHORT%20SELLING%20%20%283%29.pdf


Significant regulatory initiatives:

“Short Selling and certain aspects of Credit Default Swaps” http://ec.europa.eu/internal_market/securities/docs/short_selling/20100915_proposal_en.pdf


Executive summary

- Failing institutions can be managed through a crisis and recapitalised without threatening the stability of the entire financial system or requiring government intervention and taxpayer support.
- Two mechanisms - “bail-in” and “contingent capital” - could be deployed to allow failing firms to continue in business rather than face liquidation.
- Both options would be implemented on the firm reaching a pre-defined trigger and would be far better solutions than liquidation, as both depositors and employees would be protected and the likelihood of contagion reduced.
- In each case, the bank’s shareholders would bear the loss through devaluation or dilution of their equity.
- Critically, neither option requires capital support from taxpayers or a pre-capitalised fund for providing liquidity.

Current reform proposals are focused on strengthening bank capital and improving resolution regimes to ensure that taxpayers are not called on again to resolve any future crises in the financial sector. AFME believes that having in place clear, coordinated, cost-effective policies could help firms establish appropriate recovery and resolution plans to support these objectives. In this chapter, we set out some initial thoughts on the topic; our own work is at a relatively early stage and will be further developed in consultation with other interested parties, including investors.

The need for resolution authority

As noted in previous chapters, in a competitive market and economy, there is always a risk that financial firms will fail but a failure of an individual institution should not be viewed as a failure of the market or the financial system itself. That said, firm failures do bring many challenges so regulatory authorities should be granted resolution powers that allow them to manage such failures without bringing into question the viability of the entire financial system and resorting to taxpayer funds to rescue failing firms. All major jurisdictions may benefit from having in place resolution powers that apply to investment banks.

One model is the stabilisation powers embodied in the UK Banking Act 2009 (and the US Dodd-Frank Act) for transfer to a private sector purchaser, bridge bank or temporary public sector ownership.

---

8 In Europe, resolution powers could be extended to the more broadly defined group ‘investment firms’ under MiFID, and the scope of firms to whom HM Treasury is considering making available the Special Administration Regime. As an aside, the proposed Special Administration Regime which aims to improve the efficiency of administration for investment firms is somewhat helpful but the absence of any resolution powers means that it will likely fail to ensure an orderly wind down or prevent systemic contagion.
However, while stabilisation powers are critical for managing failures, mechanisms designed to prevent failure are far more preferable. Two such mechanisms, namely “contingent capital” and “bail-in”, could be used to bolster systemic stability without the use of public funds. Each is described below and, in more detail, in Annex 2 to this document.

Contingent capital requires no new powers. For bail-in, the authorities would need to be granted additional powers to enable them to implement recapitalisation plans that allow selected tranches of debt to convert to equity. In this situation, shareholders effectively have the value of their holdings negated just prior to, and in lieu of, putting the firm into receivership.

The potential drawback is that the powers described above are, or can be, enshrined in country-specific laws, which inherently creates a potential imbalance when dealing with institutions that operate in more than one state. Thought would need to be given to whether the following are needed:

• a European cross-border resolution regime for the global banks; and
• common rules on deposit insurance so that states are not forced to bail out depositors of a foreign bank.

The development of a truly effective protocol for cross-border cooperation with the other non-EU major jurisdictions should be a high priority for policymakers. Contingent capital or bail-in may be useful here since they avoid formal bankruptcy and thus any difficult cross-border burden sharing negotiations.

How bail-in works

Bail-in is a procedure that lies somewhere between a recovery plan (for equity injections, asset divestitures and M&A options) and a resolution plan for liquidation. A bail-in would recapitalise a firm as a going concern by converting selected tranches of unsecured debt (and preferred stock) to common equity, similar in some ways to a reorganisation effected under Chapter 11 of the US Bankruptcy Code. As this would be undertaken without any requirement to consult shareholders or creditors, it could happen very quickly – over a weekend, for example – thus reducing the risk of an adverse or systemic market reaction.

A bail-in could be implemented by the relevant authorities upon the same, or similar, triggers that see resolution powers employed under the recently adopted UK Banking Act, US Dodd-Frank Act, the proposed German Restructuring and Orderly Liquidation of Credit Institutions Act and similar laws in other countries.

“While stabilisation powers are critical for managing failures, mechanisms designed to prevent failure are far more preferable”
The key issues of a bail-in are:

- the mechanics of implementation;
- classifying the debt and securities that will be subject to the bail-in;
- the need to avoid acceleration of debt instruments or unwinding of financial contracts; and
- the possible need to provide liquidity for the recapitalised firm.

Typically, liquidation of a firm is very inefficient and destructive in the loss of enterprise value and jobs. The loss not only hits the firm in question, and other organisations with which it trades, but also multiplies among the wider economy that provides services to that firm and relies on its custom. This “loss multiplier” effect was one of the striking features of the recent crisis and a principal driver of the late 2008 market gridlock. Arguably, bail-in could have prevented this.

How firms and markets would react to a convincing bail-in framework must also be considered. A bail-in policy could positively influence market behaviour for certain classes of counterparties – for example, if certain customer and liability sectors (insured deposits, derivatives, repo) are protected they should be less prone to flight risk if rumours about a bank’s health start to circulate. This would lessen the chance of a repeat of the “accelerator” effect seen in the last crisis.

Bail-in would protect depositors and create an increase in capital that would be capable of absorbing losses far greater than those seen in the recent crisis and would reduce systemic risk by avoiding costly and damaging liquidations. It may also reduce the impetus for overly-conservative capital requirements, which is being driven by the same desire to eliminate the need for publicly funded bailouts but has the undesirable effect of stifling economic growth.

Perhaps most importantly, as well as reducing the cost of big bank failures, and the likelihood of them occurring, bail-in would also improve confidence and certainty so would reduce the risk of contagion, which has a huge impact on markets and economies.

The impact of bail-in on the cost of funding needs to be further considered by member firms and buyside firms. In particular it would be helpful to assess how that impact differs from the exercise of other resolution powers such as the state’s ability to establish a bridge bank, liquidate or sell a firm.

Recovery and resolution plans

Much attention has been focused on the idea that financial institutions should produce “living wills” – in essence recovery and resolution plans that would enable failing firms to exit the market with minimal systemic disruption. AFME supports this initiative. In our view, such plans should:

- allow a degree of flexibility to enable firms to adapt them to their particular business model and operations;
- not be used as a means to impose arrangements that regulators require for other reasons (e.g. subsidiarisation requirements);
- put forward strategic actions as a generic “menu of options”, to allow for the unpredictability and complexity of any particular stress scenario;
- contain explicit details on the composition of the regulators’ Crisis Management Group (CMG) that would act in crisis situations; and
- detail an agreed approach and the protocols that would be used in creating a “common language” on how the CMG would deal with crisis situations.

Ideally, cross-border firms would be required to have only one resolution plan so that inconsistency and incompatibility of objectives and approaches can be avoided.

For recovery plans it would be worthwhile exploring the possibilities offered by a firm’s issuance of so called “contingent capital” – a self-operating security through which capital levels can be replenished in times of distress without direct regulatory involvement.

The authority to implement a bail-in could be included in the resolution powers of national regulators, with firms required to assist them in developing bail-in plans.
How contingent capital works

Historically used by the insurance sector to provision against one-time losses, contingent capital is issued in the form of notes convertible into equity upon the issuer’s hitting a pre-defined trigger. It has recently been used by several AFME member firms to restore their capital levels post-crisis.

The benefits of contingent capital are:

• The improvement to a firm’s capital levels would come well in advance of it falling below minimum regulatory capital requirements, while also serving as an amber warning to regulators and to the firm itself to de-risk, de-leverage or seek an M&A solution.

• It is self-operating and, with the exception of ensuring that from a prudential perspective the trigger is appropriately set, requires no regulatory involvement, although it is self-evident that regulatory authorities or central banks would have an interest in monitoring events and would need to be kept fully informed. Transparency and clarity to the market is increased and could help prevent a localised problem from spiralling into a systemic crisis.

• It could be designed to dovetail with the reinvigorated Basel 3 minimum capital requirements.

Despite the benefits, there is scepticism from some parts of the investing community who argue that, like hybrids, contingent capital is a gimmicky, complex, non-transparent security that avoids raising core equity. Some fixed income investors assert that contingent capital’s equity features make the asset class ineligible for fixed income mandates. Another concern is that rating agencies would not rate contingent capital because it is not debt, and it should be excluded from fixed income indices. A further concern is that this new type of security may not be suited to some of the potential issuers and would make sense only if considerable amounts of contingent capital could be placed with investors.

Although it does bring challenges, appropriately structured contingent capital could be a highly effective recovery tool that would ensure firm-specific issues are addressed well before they become a systemic crisis.

Self-evident from these proposals is that where a well-considered resolution and recovery regime is in place there should be no need for taxpayers to support failing institutions, nor for a significant pre-capitalised fund to provide liquidity or capital during the resolution or recovery phases.

Further reading:
Institute of International Finance, “Preserving Values in Failing Firms,” Submission to the FSB (2 September 2010)

British Bankers Association, “Resolution and Unsecured Creditors” (24 August 2010), www.bba.org.uk


JP Morgan Credit Research Note, “The Ins and Outs of Bail-ins, Regime Change for Bank Senior Debt?” (6 September 2010)

Significant regulatory initiatives:
Basel Committee on Banking Supervision, Consultative Document “Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability,” (1 October 2010) http://www.bis.org/publ/bcbs174.pdf?noframes=1

European Commission, Directorate General Internal Market and Services, “Roundtable on Debt Write Down as a Resolution Tool,” (10 September 2010)
As we have shown throughout this paper, systemic risk can best be tackled through a combination of sound prudential regulation, a robust mechanism to tackle failure and a consistently high standard of risk management and corporate governance within financial institutions themselves.

To achieve this, the financial services industry, legislators and regulators will need to work together towards agreed objectives and with a shared understanding of the various tools available to each of them and how they can be most effectively deployed. In many instances, it may be that suitable rules already exist but have been implemented or enforced inconsistently. What must be avoided are over-prescriptive or blanket rules that could slow down the return to economic growth and hinder the banks’ ability to finance the real economy without achieving the ultimate goal of reducing systemic risk.

“A robust and sustainable regulatory regime will be an admirable legacy”
Much has already been achieved since 2008. For example, the industry has largely recapitalised (although as noted in the report, further capital will be required to meet the likely demands of regulators); there have been numerous industry-led initiatives to improve transparency and stability in the OTC markets; corporate governance procedures have been strengthened; and remuneration practices have changed, in line with the recommendations endorsed by the G-20.

AFME believes that the priorities now should be:

- To move away from the notion that individual firms should be designated as “systemically important” and, as a result, be subject to additional prudential requirements;
- To agree prudential requirements that meet the shared risk management goals of regulators and industry but do not stifle the financial sector’s ability to undertake its primary functions in support of the wider economy;
- To put in place a robust cross-border resolution and recovery framework that would reduce the risk of contagion when firms fail;
- To continue with the welcome reforms in market infrastructure to reduce further the potential for systemic risk while maintaining the flexibilities that foster competition, innovation and market stability; and
- To ensure that corporate governance reform is implemented in a way that unequivocally places the responsibility for managing risk within financial institutions with those most appropriate and most qualified to do so: the institutions’ own Boards.

If these objectives can be met the financial system will be stronger and more resilient than ever before. AFME and its members look forward to supporting the authorities in developing a robust, internationally coordinated, proportionate and sustainable regulatory regime. Achieving this will be an admirable legacy for future generations.

“The financial services industry, legislators and regulators must work together towards agreed objectives”
1 Executive summary

1.1 AFME referred to regulatory approaches and tools in its response – through its affiliate organisation the GFMA – to the Basel consultations of last December. In this paper AFME sets out good practices for the “enhanced supervision” of financial institutions. The objective of this approach is to mitigate systemic risk by improving the regulators’ ability to identify threats at an early stage and address them before wider intervention is necessary.

1.2 Whilst an important principle that needs to be preserved is that firms govern and take responsibility for themselves, it is accepted that supervisory activity over firms’ behaviour and resources has to improve and become more effective. To some extent enhanced supervision represents the formalisation and consolidation of supervisory practices that have evolved over time and have been given impetus by the recent crisis.

1.3 AFME believes that an approach focusing on enhanced supervision should better secure the objective of maintaining financial stability than imposing standard surcharges on firms deemed to pose a systemic risk by reason, for example, of their size. Enhanced supervision, rather than surcharges applied across a given class of firms, better ensures that the right amount of capital is held in the right places in the financial system as a whole. The blanket application of capital, over and over the contemplated Basel 3 standards (that are to be applied generally across all banks) merely provides false comfort – because it is insensitive to changes in risk brought about by market developments – and systemic risk may be better addressed through enhanced supervision building on the current Pillar 2 regime.
1.4 In this document, we expand upon what constitutes an enhanced supervisory approach. In summary it must:

- be capable of making the link between the activities and risks of the individual firm and the risks to the wider financial system;
- be grounded in a deep understanding of supervised firms’ business models, and the risks inherent therein;
- be sufficiently flexible and risk-based, to ensure that capital and supervisory resources are targeted appropriately;
- be sufficiently responsive, continuous and consistently applied so that emerging risks are identified and tackled at an early stage;
- ensure that supervisors have the appropriate powers and resources; and
- include appropriate safeguards on supervisory action.

1.5 We also suggest that enhanced supervision is best judged by reference to five targeted outcomes:

- supervisory expectations are transparent and benchmarked to reflect a firm’s peers and the markets in which it operates;
- assessment of governance and culture forms an integral part of the risk profile of any firm;
- clear linkage is demonstrated between qualitative and quantitative approaches to supervision;
- timely and targeted supervisory interventions avoid a “one size fits all” approach; and
- market confidence increases as a consequence of enhanced supervisory oversight.

1.6 For enhanced supervision to be successful it must be underpinned by a culture of challenge and cooperation on both sides of the regulatory fences: firms must be willing to work with their supervisors at both the solo and consolidated level in a transparent and open fashion; supervisors must be ready to challenge and proactively influence outcomes.
2 Introduction

2.1 The need for better and more effective oversight and supervision is being addressed by the G-20 – the Toronto Communiqué highlighted that new and stronger rules need to be complemented with more effective supervision and oversight. The G20 has asked the Financial Stability Board (FSB), in consultation with the International Monetary Fund (IMF), to develop recommendations to strengthen oversight and supervision, specifically relating to: (i) the mandate, capacity and resourcing of supervisors and (ii) specific powers, including early intervention, which should be applied proactively to identify and address risks.

2.2 The objective of addressing systemic risks in order to minimize the likelihood of serious threats to the system is best achieved through supervisors enhancing their supervisory relationships with firms such that risks are clearly understood and emerging risks identified. Working with firms on identification, understanding and management of risk should be the main supervisory tool through which systemic risk is managed.

2.3 This enhanced supervision must be grounded in a deep understanding of supervised firms’ business models, and the risks inherent therein; it must be flexible and risk-based, to ensure that supervisory resource and action is targeted appropriately; it must be sufficiently responsive, continuous and consistently applied so that emerging risks are identified and tackled at an early stage; and it must be capable of integrating micro- and macro-prudential supervision, to make the link between the activities and risks of the individual firm and the risks to the wider financial system.

2.4 The recent crisis has already brought about considerable changes to supervisory practice, including more intensive supervision in many countries, especially of firms with greater systemic importance. There has also been a significant and targeted increase in the level of capital and liquid funds held by firms, coupled with better risk management and contingency planning (including work on the introduction of formal recovery and resolution plans).

2.5 In expectation of an upcoming Basel consultation on SIFI AFME has been exploring the case for imposing capital surcharges on firms considered to pose a systemic risk. The argument against surcharges is that they are less able to be adapted to emerging risks and do not help to ensure that the right amount of capital is held in the right places in the financial system. Moreover, before any further quantitative measures are imposed due consideration needs to be given to the changes being introduced via Basel 3 reforms and the calibration of the package.

2.6 We believe that the combination of better risk management and contingency planning in firms and enhanced supervision as we explain would mitigate the risk of future crises much more effectively and proactively than the blanket application of capital above revised Basel standards.
3 Targeted outcomes

3.1 The effectiveness of enhanced supervision will be measured by reference to five targeted outcomes:

*Supervisory expectations are transparent and benchmarked to reflect a firm’s peers and the markets in which it operates.*

3.2 In addition to having a solid understanding of individual firms’ business models and risk profiles, supervisors must be able to benchmark and compare the structure, operations and performance of firms across the industry. Outliers may indicate a need for closer scrutiny. To make appropriate comparisons, supervisors should consider:

- overall business models including sales and distribution arrangements; operating environments and financial structures;
- operating performance, including the use of market intelligence, matched to regulatory returns to identify emerging risks;
- business and risk management practices and the manner in which firms assess the new or specific risks being taken on; and
- the overall governance structure and its effective operation.

*Assessment of governance and culture forms an integral part of establishing the risk profile of any firm*

3.3 Sound governance is a cornerstone of regulation and enhanced supervision should be based on an understanding of the culture and behaviours of firms as a consequence of senior management actions and the role of boards and committees with oversight responsibilities. The quality of governance and the culture which it engenders should be reflected in all of a firm’s activities, from dealing with individual customers to strategic decisions on risk allocation.

*Clear linkage is demonstrated between qualitative and quantitative approaches to supervision*

3.4 If regulators are aiming to cover a broader spectrum of elements relating to any individual firm, they will need to adopt a wider range of approaches that combines quantitative and qualitative tools and does not place undue reliance on either. For example, the recent crisis has highlighted the dangers of focusing on quantitative data rather than qualitative factors (or indeed, the dangers of inadequate quantitative reporting combined with gaps in qualitative analysis of factors) such as whether a firm’s executive management teams and board are made up by individuals that can challenge business decisions, or whether the firm is operating within its stated business goals and strategy, and whether that strategy is sustainable.

3.5 This will require a more continuous dialogue between the firm and its supervisors, with less reliance on ‘big bang’ reviews occurring say once every two years (although, depending on a firm’s business these also have their role). The internal processes within the regulator should be transparent and flexible enough to accommodate that breadth of dialogue.
Timely and targeted supervisory interventions avoid a ‘one size fits all’ approach

3.6 A broader analytical framework and dialogue should identify areas of concern at an earlier stage and allow for the development of a tiered approach to intervention (if that is necessary). For example, indications of a firm starting to stray outside its agreed risk parameters would lead to a different intervention than would be the case where there had been dramatic impairments and sharply reduced capital ratios. One might be a precursor to the other and could be a situation where early intervention might avoid far reaching and costly measures at a later date.

Market confidence increases as a consequence of enhanced supervisory oversight.

3.7 Collectively, these outcomes should result in confidence in the prudential soundness of the firm. In turn, it should promote mutual trust, prevent arbitrary regulatory actions and counter the assumption that should be surcharges applied across a given class of firms, above the revised general Basel standards, is the only (or even a superior) supervisory response to a risk emerging within a firm.

4 Enhanced supervision: good practices

Culture of cooperation and challenge

4.1 Underpinning enhanced supervision is a culture of challenge and cooperation. Firms must be willing to work with their supervisors at both the solo and consolidated level in a transparent and open fashion. Firms need also to welcome a more rigorous assessment of their business model, their business strategy and senior management.

4.2 On the supervisory side, there must be a cultural disposition for challenge and for proactively influencing outcomes, rather than merely reacting to events. However, this challenge must stop short of the supervisor acting as a shadow director. [Also see Section 4g on Safeguards on Supervision].

Key features

4.3 Whilst an important principle that needs to be preserved is that firms govern and take responsibility for themselves, the extent of targeted supervisory activity over firms’ behaviour and resources has to improve. We are proposing a holistic approach to supervision and it must:

- Integrate macro and micro supervision, engaging firms in a dialogue on their own risks as well as their views on risks in the market;
- Build on existing qualitative and quantitative tools and practices and allow for flexibility so that supervision evolves in response to emerging trends and risks;
- Identify how the style of supervision may need to change to ensure that it is sufficiently responsive;
- Promote consistency in supervision across and within jurisdictions by encouraging collaboration among supervisory authorities to eliminate duplication or gaps in supervisory coverage;
- Recognise the implications in terms of supervisory resources and mandate; and
• Ensure that safeguards are in place to avoid inefficiencies associated with poorly targeted supervisory requests, over-familiarity of supervisors with the firms they oversee leading to inadequate challenge and disproportionate supervisory actions.

a Integrated Macro and Micro Supervision

4.4 During the recent financial crisis, there was insufficient focus on the overall risks which had built up in the financial sector. Instead, supervision was aimed at individual institutions without due regard to the state of the underlying economies together with the connections between financial institutions and with other elements of the financial system. It is essential to have a macro-supervisory framework which (a) will identify exuberance in financial markets (for example, the creation of asset price bubbles) and (b) has mechanisms to enable the supervisor to dampen that exuberance where it will create a risk to financial stability. That may mean the introduction of industry-wide measures to curtail the supply of credit, for example, through higher capital ratios, or measures focused on credit provided to particular sectors of the economy that take into account the business models of individual firms.

4.5 A properly functioning macro-prudential framework would:

• Enable supervisors both to raise - and, indeed, also lower - the aggregate amount of capital within the financial system to reflect the overall levels of risk, with that broad industry guidance being translated into recommendations for individual firms, implemented by the day-to-day supervisory team.
• Engage firms in a dialogue with their supervisors on their own risks as well as their view on risks in the market.

b Building on the continued evolution of supervisory practices

4.6 To some extent, enhanced supervision represents the formalisation and consolidation of good supervisory practices that have evolved over time and been given impetus by the recent crisis.

4.7 In the context of the Basel II framework/CRD these practices reflect what is known as Pillar 2 (in its broadest sense). Pillar 2 concerns the dialogue between the supervisor and the firm on the firm’s risks (including risks, such as reputational risk or strategic risk, that are not easily quantifiable and where a more qualitative approach is needed), and the amount of capital the firm needs to support its economic activities on a forward looking basis. It requires that both firms and supervisors assess a firm’s capital needs taking into account (i) the firm’s ability to identify, control and monitor its risks and (ii) its capital plan, given its business strategy.

4.8 Pillar 2 has always required that supervisors and firms continue to develop the tools and processes used to engage in this dialogue. However, since the crisis, many supervisors have markedly changed their broad approach to this dialogue and to supervision. Supervisors that had previously adopted a narrow approach or had sought a ‘light touch regime’ have boosted their resources to allow them to be more proactive.
4.9 As a consequence, there is greater scrutiny and challenge of firms’ business models, aimed at understanding the key drivers of risk and the sustainability of businesses. This enhanced approach to supervision is also backed up by greater willingness to use corrective action.

4.10 In the Pillar 2 context this has translated into an increased use of more robust stress tests, an increased focus on risks such as funding and liquidity risks (which previously had a lower profile), greater scrutiny of corporate and risk governance, and greater attention paid to colleges of supervisors (now specifically mandated by CRD2 for example). Pillar 2 always provided supervisors with scope to apply a form of capital surcharge to individual firms. We expect to see supervisors setting firm specific capital ratios based on an assessment of all risks, including those which are not easily quantifiable.

4.11 The elements that make up enhanced supervision should not be rigidly defined. Enhanced supervision should be characterised by guiding principles and based on a methodology that supports a structured approach to supervision but allows for some flexibility in order to capture the different circumstances of different firms. It should be used as a tool to: (i) build up a robust relationship between supervisors and institutions; and (ii) support supervisory action at a sufficiently early stage to avoid, for example, capital falling below minimum requirements.

4.12 AFME supports the continued development in supervisory practices, with Pillar 2 continuing to be the building block for the further evolution of supervisory processes and tools. The on-going dialogue between the firm and its supervisor should be structured and encompass both a qualitative and quantitative discussion of a firm’s risks and risk management processes, based on the firm’s own assessment and the supervisors’ analysis and challenge of this assessment.

c Style of supervision: consistency in practice

4.13 To a large extent, supervisors assess similar sets of risks using tools that are largely common to all. Variations in the different outcomes for firms arguably arise over the different styles of supervision - driven by both the ‘supervisory philosophy’ of the supervisor (e.g. ‘top down’ or ‘bottom up’ approach, level of intrusiveness and culture) and the supervisor’s internal framework for assessing risks (e.g. resource allocation, programme of work and depth of the analysis which inform decisions). Each style of supervision has its benefits and costs, but while there is no one ‘ideal model’, a particular question is the degree to which supervisors undertake their work at a firm’s premises.

4.14 Generally supervisors will undertake a combination of offsite and onsite reviews although the balance varies. At one end of the spectrum, historically the Spanish regulator, for example, maintains a permanent onsite presence (in common with the Fed/OCC) for its larger firms; while, at the other end of the spectrum some supervisors carry out mostly desk-based reviews and ‘outsource’ onsite work to third parties such as audit firms.

4.15 Most supervisors will not be based continuously onsite, but will put in place a programme of visits (in the form of inspections /audits /reviews /meetings) over a specific period of time. For example, the UK FSA uses its existing supervisory knowledge of larger firms gained through its ‘close and continuous’ programme, supplemented by additional specific information requests, to determine the scope of its periodic onsite ARROW
risk assessment work. This in turn will inform the ‘Risk Mitigation Programme’ which is likely to include a number of more detailed visits on particular themes ranging from a few days to weeks onsite. In other jurisdictions, such as France, supervisory programmes take the form a series of diarised onsite inspections that may last weeks or months, depending on the nature of the inspection. In Germany, detailed audits are performed onsite over extended periods of time. Many home regulators will also carry out visits to operations outside the home state. In doing so, coordination with the host regulator is essential to avoid duplication and an undue burden on the firm.

4.16 Offsite reviews involve analysis of regulatory returns, management information and additional information (such as policies and procedures) and/or numerical data provided by the firm. Often a desk-based review is used to determine the extent of follow-up and to prepare for onsite work, and can be used to inform a longer-term programme to be carried out over a set period of time. Onsite work can comprise testing of systems and procedures, interviews, etc., as well as more detailed review of files and records.

4.17 Theoretically, a third party review can be equally effective as one undertaken by the firm’s supervisor and holds the promise, for the supervisor, of being a less resource-intensive approach. Its drawbacks, however, are notable. It lacks the benefits associated with a continuing dialogue between a firm and its supervisor. Furthermore, the ability of the supervisor to put findings in context can be compromised.

4.18 Both offsite and onsite reviews are resource-intensive for the supervisors and the firm. However, they can be mutually beneficial if the purpose of the review is clearly understood in advance and information requests are focused and targeted. It is also important to recognise that an approach driven first and foremost by documentation can lead to long delays in decisions. In all cases the timeliness of the feedback and communication of required actions is very important to ensure their effectiveness.

4.19 Finally, it would be overly simplistic to compare the supervisory resources allocated to comparable groups in terms of the number of staff as this would suggest that a direct relationship exists between that and the effectiveness of the supervision. There must be an appropriate blend of technical expertise in relevant risk management disciplines, understanding of the firm’s business model and the markets it operates in and an ability to understand its risk profile. This is a particular challenge where the group has significant operations in jurisdictions where the markets are inherently more complex than its home market. Supervisors should be open in sharing both technical expertise and their knowledge of local markets.

4.20 Enhanced supervision implies a style of supervision that may increasingly feature a propensity for more onsite visits; or, at the very least, improved and ongoing, rather than episodic, dialogue between firms and supervisors. While this approach presents costs, if properly managed it can yield benefits for the firm and its supervisor when supported by the timely analysis of firms’ management information and reports.
d Style of supervision: consistency across jurisdictions

4.21 More recently, governments have paid more attention to regulatory structures. For example, US and UK moves towards a “twin peaks” structure, under which prudential regulation and consumer protection are separated, are partly designed to facilitate greater focus on prudential matters. In the EU, the upgrading of the Lamfalussy Level 3 supervisory committees into authorities, with greater oversight and rule making powers from early 2011, offers the opportunity for a more streamlined and coordinated approach.

4.22 Nevertheless, as indicated under section 4a above, Pillar 2 is at the heart of enhanced supervision no matter the structure. Pillar 2 should not seek to categorise institutions according to systemic importance but it should provide the tools that help to ensure that additional capital is allocated where it is needed (for example, where concentration risk is greater).

4.23 The effective implementation of Pillar 2, in the context of cross border firms, needs to be complemented by the development of guidelines for strengthening cooperation between home and host supervisors. We recognise and support efforts by regulators to promote a framework for supervisory colleges that will help to ensure consistent understanding of a firm’s risk profile across international borders.9

4.24 Effective collaboration between supervisors relies on the minimisation of duplication but can cover issues areas such as risk assessment, stress testing and model validation.

4.25 In sum, enhanced supervision should help to ensure that variations in the application of Pillar 2 across jurisdictions are reduced.

e Management of the supervisory relationship

4.26 Enhanced supervision requires the oversight and engagement of senior supervisors and firms’ senior management and must be supported by an established governance process.

4.27 The firm’s governance should identify the main point of contact for the local regulator, lead regulator or college. In addition to addressing how the firm should interact with regulators and supervisory colleges, it should also include processes for managing and communicating information relating to supervisory visits and reviews.

4.28 Regulatory governance should identify key supervisory staff responsible for supervising the firm and include a programme of planned reviews/inspections. The supervisor should also provide feedback to the firm from senior supervisory staff and the firm’s college of supervisors.

f Supervisory requirements

4.29 Enhanced supervision requires that supervisors be provided with a mandate to act and have the skills and resources to undertake this form of supervision.

---

9 We note that in the Basel Committee’s July 2009 paper Enhancements to the Basel 2 Framework, it is stated that “Colleges should not be seen as a substitute for effective national supervision nor undermine the legal and prudential responsibilities of respective supervisors. Col leges are not intended to be decision-making bodies but should provide a framework to enhance effective supervision of international banking groups on a consolidated and solo basis, and could inform decision-making in that regard.”
Supervisory mandate

4.30 Supervisors must be able to intervene, so consideration must be given to the powers that they need and how they should be allocated across supervisory teams and senior supervisory staff.

Supervisory resources

4.31 An effective dialogue with firms requires experienced senior and middle level supervisory staff. Supervisors must:
   i. have specialists teams with detailed technical knowledge of risk management practices and processes;
   ii. be familiar with high risk strategies;
   iii. have an understanding of innovative products and their real risks and benefits; and
   iv. have the confidence to challenge conventional wisdom and the ability to engage in contrarian thinking.

4.32 Supervisory teams possessing this mix of skills and aptitudes are difficult to build and retain, but this challenge must be met if the objective of maintaining financial stability is to be achieved.

4.33 One way to train supervisory staff, is via secondments (supervisors to banks) although retention can be an issue. Another way, is for regulators to employ – as some already do - established industry figures who want to undertake a public service role passing on their knowledge and insights. These figures could be used as advisors and/or be integrated, to varying degrees, in supervisory teams where they can more effectively challenge senior industry figures than less experienced supervisory staff might feel confident doing.

g Safeguards on Supervision

4.34 Enhanced supervision should also include safeguards to avoid diminishing returns associated with poorly targeted supervisory requests, unjustified supervisory action or, equally problematic, supervisory inaction.

Managing diminishing returns

4.35 The enhanced supervision approach has to consider the diminishing returns afforded to supervisors and increasing costs for firms providing real time and granular data to supervisors if the purpose is not well directed. Obtaining data for its own sake (without the tools to interrogate or analyse it properly) can lead to poor decision-making, cause inefficiencies and be distracting both on a micro and macro-level. Also, unless supervisors are cognisant of the differences between firms, moving away from firms’ own estimates to the increased reliance on supervisory calculations / models / stress tests will not yield the benefits envisaged.

Supervisors getting too close to the firms they regulate (i.e. 'going native')

4.36 The risk of the supervisor/firm relationship becoming to close has always existed. Arguably, with enhanced supervision there is an increased probability that the supervisor may be unable to dissociate its view of risks being undertaken by the firm from that of the firm’s management. This could, in turn, lead to a lack of rigorous challenge and inadequate or inappropriate supervisory responses.
Factors which might influence the nature of the relationship include cultural or political issues as well as low turnover in the make-up of the supervision team and firms’ management.

The terms of engagement between firms and supervisors must address the problem of supervisors becoming too close to the firms they supervise. While this suggests putting in place limits on the time individual supervisors are assigned to any individual firm (something which is in place in some countries), this should be balanced with the need to maintain continuity within the supervision team by staggering turnover. This will help to ensure that a supervisor’s knowledge and understanding of the firm is not superficial.

Unjustified supervisory actions

Where supervisory actions appear unjustified, this is likely to manifest itself as an uneven playing field for the firm (or firms) in question. There are in place in certain jurisdictions appeals processes which can be used to challenge decisions. However, even if successful this is likely to be a lengthy and possibly expensive legal process. Therefore it is worth considering whether preventative measures can be put in place to minimise the likelihood of this situation arising in the first place. This could include some form of peer review of decisions made; although we recognise that this is not without political difficulties depending on the make-up and remit of the peer group. This would also require the other regulators in the peer group to have access to the detailed information provided to the home regulator so that the grounds for the latter’s decision could be assessed.

Joint decision-making through colleges and other arrangements may go some way to addressing this risk, although this is more likely to be helpful in the context of decisions relating to solo entities within the same cross-border group, rather than [group] assessments across the financial services sector. Increasingly detailed disclosure by regulators about their decision-making criteria (and potentially ‘anonymised’ statistical information) may go some way towards creating consistency, in the same way that increased transparency by firms is intended to drive good practice.

Supervisory inaction

In some instances supervisors may be outliers in their willingness to take action, which again may lead to an uneven playing field. In addition to being detrimental to firms, in the medium to long run, this undermines market confidence in the local regulator and the firms it supervises.

Inaction associated with the inability of a supervisor to identify that a decision is required is difficult to tackle if the risks being run by the firm are not visible to other regulators who could intervene. Increased transparency and disclosure about the risk profile of a firm could either prompt action directly or indirectly as a consequence of a market reaction. This coupled with timely dialogue between authorities on emerging or evolving risks could lower the likelihood of risks being missed altogether.
Annex 2
Contingent Capital and Bail-in

This paper was first published in August 2010 with the aim of generating a wider debate among policymakers and the financial services industry, including both sell-side and buy-side market participants. It sets out many of the issues that would need to be addressed if bail-in or contingent capital were to be developed as resolution mechanisms.

1 Executive summary
2 Contingent Capital
   a Background
   b Trigger
   c Ratings
   d Developing a market in contingent capital bonds
   e Conclusion
3 Bail-in
   a Introduction
   b Mechanic
   c Classifying instruments subject to bail-in
   d Acceleration of financial contracts
   e Liquidity
   f Lehman as case study
   g Cross-border implications
   h Impact on capital resources and debt pricing
   i Potential feedback effects and market discipline
   j Summary

Annex 2A
Annex 2B
1 Executive summary

4.43 AFME supports the authorities’ objective of strengthening bank capital and improving resolution regimes to eliminate the need for taxpayer recourse in any future crisis; and their work to develop clear, harmonised and cost-effective policies in the major jurisdictions to establish recovery and resolution plans in support of this objective.

4.44 We support both the optional use of contingent capital as part of a firm’s recovery plan and giving national regulators the authority to implement a fast-track recapitalisation via debt-equity swaps executed just prior to (and in lieu of) receivership or liquidation (a “bail-in”). The G-20 has charged the Financial Stability Board (FSB) with addressing both of these options for the 2010 Seoul summit. With the aim of generating a wider debate among policymakers and industry, this paper sets out the issues for consideration when developing proposals for contingent capital or bail-in.

4.45 “Contingent capital” is a recovery (rather than resolution) tool that serves to replenish a firm’s capital by converting a debt instrument to equity (or effecting a write-down of the debt instrument) well before a firm becomes distressed. The prospect of dilution or a write-down incentivises management to monitor the firm’s solvency and take corrective action earlier. We believe that appropriately structured contingent capital could serve as a bridge between the prudential benefits of higher capital levels and the negative growth consequences of increased capital requirements.

4.46 Lying between the traditional concepts of recovery and resolution, “Bail-in” differs from receivership in that it would look to preserve normal customer activities and maintain the firm as a going concern. In this way, it is similar to a consensual corporate reorganisation undertaken to maximise recoveries to investors beyond what they would receive in a liquidation. For the bail-in to succeed, it must not constitute a trigger for bankruptcy, accelerating debt instruments, nor the unwinding of financial contracts.

4.47 The restructured firm could still be liquidated or sold off if that were the most favourable outcome, but a bail-in would expand options available in the event of distress. It would be used in cases where it is likely to achieve a better outcome for counterparties, creditors, the wider market and the taxpayers. We believe bail-in could foster market discipline by shifting the burden of losses first to shareholders and then to unsecured creditors, using a fair, transparent and rules-based process.
4.48 Neither contingent capital nor bail-in would require taxpayer capital injections to improve the firm’s capitalisation. However, neither directly addresses a notable feature of the recent crisis – liquidity runs. Liquidity should not be a significant problem under contingent capital if the conversion is structured to occur well in advance of significant distress. In contrast, a bail-in is designed to occur much later, when the firm is under significant distress. While a newly recapitalised firm should be in a much stronger position to attract private sector financing, most (but not all) firms undergoing a bail-in would need a strong plan to address liquidity concerns as a temporary matter. A range of tools should be considered for supporting the firm early in the transition to address the period when market fears are likely to be significant. Such tools could include bank consortium support or allowing the use of super senior “DIP-style” financing; further liquidity tools could also incorporate direct or indirect central bank procedures.

4.49 As for implementation, the conversion of contingent capital into equity is self-operating pursuant to the terms of the instrument. A bail-in, on the other hand, would require new legislation. The firm would maintain the necessary information for a bail-in in its resolution plan (e.g. its capital and legal structure and debt:loss ratio) and, as insolvency neared, the firm and the regulators would use this information to determine the overall viability of a bail-in. The ultimate decision to implement the bail-in, and its terms, would rest solely with the regulators and be subject to (or protected from) the same challenges by stakeholders as a firm undergoing any other resolution action by the authorities.

2 Contingent Capital

a Background

1 Contingent capital is debt that provides a firm with a loss-absorbing layer of capital by converting into common equity or by effecting a “write-down” of all or part of the principal amount of the issuer’s debt upon the occurrence of a pre-determined trigger related to the issuer’s financial strength.

2 Historically used by the insurance industry to provision against large, one-time losses, since the financial crisis several AFME member firms, including Deutsche Bank, Lloyds Banking Group, Rabobank Group and Unicredit, have issued contingent capital to strengthen their balance sheets.10

3 Like debt convertible into equity, a write-down replenishes the issuer’s equity capital but in a different way. Instead of diluting the existing shareholders no new shares are issued. The value of the aggregate equity capital increases by virtue of the corresponding reduction in the firm’s outstanding debt (and corresponding decrease in value in the contingent capital security).

10 The attached Annex 2A shows two recent examples of contingent capital instruments issued by Lloyds and Rabobank, in each case creating core capital in a going concern.
A firm’s decision to structure contingent capital as an equity convertible or write-down will depend on which form is more efficient from the perspective of implied capital structure costs. Structural and legal factors may also drive the form. For example, write-down might be used by a firm without outstanding equity shares (such as a mutual), or if it is unable to secure a waiver of shareholders’ pre-emption rights under local company law. In this paper, the terms “contingent capital” and “conversion” encompass both the issuance of new equity and the write-down of debt, unless the context indicates otherwise.

Contingent capital is not considered a resolution tool as conversion occurs well before a firm becomes insolvent. It would not be legally imposed on firms, nor would it constitute an insolvency event for purposes of accelerating debt or unwinding derivatives. Regulators would not be involved when the trigger occurs.

Contingent capital must be characterised as debt for two reasons: first, to meet the requirements of fixed-income investors who will be needed to absorb supply; and second, to allow the issuer to receive tax-deductible treatment on the payment of interest, which lowers the cost of capital.

The Basel Committee, FSB and the Institute for International Finance are studying contingent capital as part of their reform packages. The G-20 Toronto Communiqué stated support for the Basel Committee’s work on contingent capital in “strengthening market discipline” and noted that “consideration of contingent capital should be included as part of the 2010 reform package.” Among its broad range of prudential powers, the US Dodd-Frank Act empowers the Federal Reserve to set firms a minimum level of contingent capital that is convertible into equity in times of financial distress.

**Trigger**

The trigger for conversion must be clear, transparent, fixed at time of issuance and easy to determine when it occurs. A trigger based on a core capital ratio set above the minimum core tier 1 capital requirements under the re-invigorated Basel III capital standards would meet these criteria. Firms should have the discretion to set the trigger in accordance with their own objectives to achieve the optimal balance between prudential and economic considerations. Factors the issuer might consider in setting the trigger are:

- To receive treatment as going concern capital the trigger should activate before any breach of the firm’s minimum regulatory capital requirements, or any other circumstances giving rise to regulatory intervention.
- The probability of breach needs to be low enough to attract a credit rating as debt and, as such, near to subordinated debt for purposes of pricing.

To ensure clarity in the market regulatory intervention must not be required to activate trigger.

The level of dilution (or write-down of debt) would be at the discretion of the issuer and driven by available pricing in the market and the impact on the issuer’s financial flexibility.

There could be a dual trigger structure whereby one trigger is set at the minimum core tier 1 capital level and a second trigger, which can be invoked by management at its discretion, is set above it. There is a view, however, that the inability of the market to predict management’s exercise of discretion would make the instrument too expensive to issue. The capital ratios could be disclosed on a quarterly basis in conjunction with the quarterly financial reports.
A trigger based on market metrics or a determination of impending systemic risk (made by a regulator) would not be effective. In addition to creating marketability issues, a trigger based on share price or market capitalisation is subject to manipulation and will almost certainly foreclose a proactive capital raise because it may fail to move the firm a safe enough distance from the trigger, which in turn will generate further negative price spirals. A trigger based on a determination of systemic risk is also unattractive, partly because it could not be used in cases of idiosyncratic risk. Waiting until firm-specific risk has spiralled into systemic risk is destabilising.

A trigger based on a forward-looking “stress tested” capital ratio is seen by many experts as too subjective and too complex. Under this scenario, financial institutions would run a quarterly stress test based on parameters set by national regulators and standard across all firms issuing contingent capital within that jurisdiction, which would evaluate the impact on balance sheets of major macroeconomic and financial stresses.

Another approach considered too complex and subjective is a disclosure-based trigger whereby firms would be required to publish extensive disclosures about their balance sheets and the impact of expected losses under certain specified scenarios. In effect this would operate as a public version of the stress test.

An argument for stress test-based triggers is that contingent capital could serve a prudential purpose beyond providing a source of equity capital alone, if it were designed to instil market discipline. The trigger could act as a virtual “electric fence” where the threat of significant dilution incentivises shareholders and management to take corrective action well before insolvency. Critics of this approach question whether this is practically achievable and whether there may be unintended consequences. A particular concern is that the threat of dilution may actually inhibit an equity raise at an earlier stage where the potential investor risks being significantly diluted in the near term. This firm also would reject write-down as counterproductive to improving market discipline because shareholders are actually rewarded upon the write-down instead of penalised.

c Ratings

Rating agencies may not rate contingent capital instruments for various reasons, including the equity nature of the instrument and the difficulty of predicting the occurrence of the trigger (as opposed to the issuer’s default under the instrument).

Unrated bonds will have difficulty attracting investors, particularly those whose investment parameters require them to invest in rated securities, and particularly in the US market where investors are less accustomed to unrated securities.

A non-investment grade rating would not preclude investor interest but it would dampen issuance volumes where investors face mandate limitations and their own increased capital requirements.

The working group is seeking feedback from the rating agencies on the rateability and structuring of the instruments.
d  Developing a market in contingent capital bonds

Investor demand will be driven by:

- the structure and terms of the instrument;
- the holder’s capital treatment for holding the contingent capital security; and
- the security’s inclusion in indices for benchmark purposes, and the like.

AFME is assembling a buy-side working group to provide investor feedback on these issues.

e  Conclusion

Effectively structured contingent capital could be an effective recovery tool, operating well before institution-specific problems could spiral into a systemic crisis, and could serve as a bridge between the negative economic growth consequences of increased capital requirements and the prudential benefits of greater capital levels.

3  Bail-in

a  Introduction

1  We agree with the authorities’ policy objective of eradicating the moral hazard of ‘too big to fail’ and avoiding the need for government bailouts in the future.

2  Existing insolvency procedures (such as administration in the UK and Chapter 11 in the US) do not work for large financial firms, except as a prelude for a disorderly liquidation, which can have catastrophic consequences. Financial firms depend critically on continuous market confidence. Such confidence will not persist through a lengthy and uncertain wind-down. Liquidation is typically an inefficient, destructive option for large companies – and is generally rejected by creditors in most industries in favour of a recapitalised going concern.

3  There have been significant steps since the crisis to expand the resolution powers available to the authorities, including transfer to a private sector purchaser, a bridge bank or temporary public sector ownership under the UK Banking Act and the US Dodd-Frank Act. Helpful as these measures are, other approaches could provide investors with a better economic outcome than a liquidation and avoid the challenges associated with government receivership or public ownership.

4  Bail-in is an approach that lies between “recovery plans” (e.g. equity issuance, asset divestiture, contingent capital) and “resolution plans” (e.g. receivership or liquidation). It would recapitalise the firm as a going concern by converting a sufficient amount of debt to equity without using any government capital injections. Execution would be fast-tracked; given the time pressures, results would be imposed (not negotiated) via a clear and fair protocol that would be transparent to investors. The legal claims of creditors would be reduced in exchange for overall value maximisation similar to a corporate restructuring. Business operations would continue normally but management would likely be changed by the regulator (as is typical for companies under statutory restructuring proceedings designed for company rescue).
5 A bail-in could produce an economic outcome similar to a consensual restructuring, but the legal procedures would need to occur far more quickly, e.g. over a weekend. If such a framework was designed in a convincing, transparent and fair manner, it could offer significant advantages over existing choices. The principal issues of a bail-in are:

a the mechanics of implementation;
b classifying the instruments eligible for conversions;
c the triggers for regulatory intervention; and

d avoiding acceleration of financial contracts and liquidity.

It would also require a coordinated change of law in major financial jurisdictions as well as understandings among the regulators of such jurisdictions. These are discussed below, together with a case study on Lehman, the cross-border implications, the impact on capital resources and debt pricing, potential feedback effects and market discipline.

b Mechanics

1 The procedures needed to execute the bail-in would be directed by the lead regulator. Firms would be responsible for supplying information sufficient for the regulator to implement a bail-in (such as liability schedules by priority class), and to assist the regulator in the exercise of its powers as necessary. Third party advisors would also probably be needed (e.g. for valuation) given the considerable work involved in a short span.

2 The lead regulator would first need to determine that the firm no longer satisfied the conditions for continued operation in that jurisdiction, and was subject to potential seizure. For example, in the UK the trigger would be if the firm was failing, or likely to fail, the threshold conditions for its FSA permissions to carry on regulated activities, which relates to undercapitalisation and liquidity. Annex 2 lays out the triggers for the exercise of resolution powers under UK, US and Swiss law for illustrative purposes.

3 The regulator would next determine whether a going-concern outcome through a bail-in would be likely to achieve better value for investors.11 If these conditions were in place, then the regulator would initiate bail-in procedures.

4 There would be three primary steps in execution:

i Assets would be written down (or reserves taken) to put the balance sheet to a more conservative position that has market credibility.

ii The amount of new equity required to support a going-concern company would be estimated. This would likely be an amount greater than simply restoring the status quo ante. A conservative estimate is needed to be convincing to the market and to avert the need for a further recapitalisation later.

iii These overall requirements would need to be translated into specific impacts on individual classes of investors. In general, write-downs would be applied to the most junior classes, starting with equity and progressing in strict order of creditor priority (up to, and including if necessary, senior unsecured debt).

---

11 In many large bank failures, the estimated going concern value would exceed liquidation value but there are potential exceptions - for example, where management has been engaged in fraudulent activity. In other situations, the firm’s funding model may make it unsuitable for a bail-in - for example, a firm financed exclusively with equity and insured deposits.
Conversions of creditor claims into equity would then progress, from the remaining junior classes up to senior unsecured classes, as needed, to achieve the desired overall capital ratio. All members of a given class would be treated equally.

5 The authorities will need to adopt rules to govern bail-ins, such as (i) the identification of the classes of instruments that could be subject to bail-in, and (ii) the elimination of requirements for consent from creditors, shareholders, listing authorities, etc.

6 As a check and balance on the authorities’ ability to impose a bail-in unilaterally, lawmakers should consider safeguards such as equal treatment of all holders of a class, clarity of rules for investors ex ante, and robust transparency to affected investors, as well as the protection of property rights. In some jurisdictions, this would require that investors be entitled to receive an amount estimated to be no less than what they would receive in liquidation.

7 Lawmakers would also need to consider legal principals under local law whereby transactions can be unwound for the benefit of the firm’s creditors, such as fraudulent conveyance or unfair preference. A guideline might be that a bail-in be subject to (and protected from) the same types of claims and causes of actions as any firm to which the authorities have exercised resolution powers, i.e. receivership, transfer to a third party or liquidation. A framework under local law for allowing (or not allowing) challenges to the valuation supporting the bail-in could be similarly modelled on how that jurisdiction treats valuation challenges under other resolution scenarios.

c Classifying instruments subject to bail-in

1 The overall approach of a bail-in is to adopt a procedure analogous to an industrial recapitalisation – the unsecured capital structure would be reorganised but liabilities that arise in the course of franchise activities would be protected (to the extent possible) in order to maximise value.

2 The standard unsecured capital sources subject to bail-in would include equity, prefereds, unsecured bonds and other similar debt, and hybrid capital instruments.

3 Franchise activities are those that a bank carries out in the ordinary course of business, such as transaction payments, settlement flows, prime services and normal derivatives. To preserve the customer franchise for the benefit of investors, liabilities associated with these activities would not be subject to haircuts. (In addition, imposing haircuts on this category would create significant practical difficulties in many large banks, given the high number of transactions that would need to be altered in a short timeframe).

4 Bail-in would also avoid haircuts to secured liabilities (i.e. normal fully-secured repo) or protected funding (insured deposits) that have been protected by historic policy.

5 Grey areas where classification might require further study include institutional deposits and short term funding. While it is possible to consider different alternative regimes, these decisions would need to be made clear as part of the bail-in regime ex ante (i.e. they cannot be decided on an ad hoc basis).
d Acceleration of financial contracts

1 A bail-in would need to avoid any insolvency-based events of default under the 1992 or 2002 versions of the ISDA Master Agreement, as well as under any other financial contracts. Absent such avoidance, the institution’s derivatives contracts could be closed out, leading to a significant loss of franchise value and expansion of liabilities for the bailed in firm. Acceleration would also create an additional pathway for stress to be propagated to other institutions.

2 This result could be obtained through legislation or regulation, or possibly via a change to ISDA protocols. For example, bail-in legislation could specify that the bail-in is disregarded in determining whether an event of default has occurred under any contracts to which the relevant institution is a party, credit support provider and/or specified entity, as is the case of share and property transfer instruments under the UK Banking Act (and the 24 hour enforcement stay under the Dodd-Frank Act).

e Liquidity

1 Liquidity concerns were a prominent feature of the recent crisis. While bail-in does not address that concern directly, it does address the root cause of illiquidity - the fear that creditors are not adequately protected by equity. Liquidity often has its own dynamics and momentum, however, and will need to be addressed specifically. After bail-in has been used a few times there may be less liquidity pressure because the market will know that funding related to franchise activities (vulnerable to runs) will be protected. Until then, a bail-in will need to be accompanied by a liquidity plan that is sufficiently strong to restore liquidity and confidence.

2 There are private market approaches that could be effective, such as a bank syndicate to provide funding post-bail-in (similar to the consortium that provided support for LTCM in 1998). However, this is an area where central bank procedures have often proved decisive due to their financial capacity and respect in the market.

3 Central bank liquidity support to a strongly recapitalised institution (i.e., one with low true credit risk) should be considered as part of a range of tools. One approach that merits particular consideration is the potential for a super-senior class of funding that could be pledged to the central bank. This could create an indirect supply of liquidity to the new institution through a facility made widely available to consortium banks. Such support would be in line with traditional lender of last resort concepts, without putting taxpayer capital at risk.
f Lehman as case study

1 Consider the case study in the table below which examines how a bail-in might have been applied in the case of Lehman. Old equity capital is written off due to asset write downs. New equity capital is created by converting Lehman’s common, preferred, subordinated and a portion of senior unsecured debt. This would be sufficient to achieve a tier 1 ratio above 20% (purposely conservative to engender market confidence).

<table>
<thead>
<tr>
<th>Old balance sheet</th>
<th>New balance sheet</th>
</tr>
</thead>
<tbody>
<tr>
<td>$25 bn equity</td>
<td>Warrants</td>
</tr>
<tr>
<td>$25 bn preferred &amp; sub debt</td>
<td>New equity (100% conversion)</td>
</tr>
<tr>
<td>$120 bn senior unsecured</td>
<td>New equity (15% conversion)</td>
</tr>
</tbody>
</table>

Remaining 85% debt is unchanged – but better rated
Secured debt, insured deposits, customers and counterparties are unaffected

2 Investors in the Lehman case study would have to recognise embedded losses of roughly $25 billion under a bail-in, considerably less than the estimated $150 billion in market losses that occurred. (The market loss estimate is based on post-bankruptcy trading levels for Lehman equity, preferred and subordinated debt - essentially worthless - and unsecured debt securities trading at approximately 20% of face value). Some argue that these losses were especially high due to the disorderly nature of the Lehman filing. While it is difficult to determine the exact components of this loss, most believe that even an orderly transition to gone-concern will destroy substantial value.

3 Although the bail-in would have reduced claims and subordinated investors, investors should still be better off in economic terms than under a liquidation. Bail-in avoids the large, unnecessary additional losses that arise in the transition from “going concern” to “gone-concern.” If Lehman had undergone a bail-in, senior unsecured creditors might have retained value equal to 85% to 95% of their original claim, rather than the 10% to 20% recovery values indicated by post-bankruptcy market trading levels.

4 The reduction in losses has important systemic implications. If the loss to creditors can be reduced from the severe levels implied by liquidation to a more modest (5% to 15%) level, stress on investing institutions will be much reduced. For example, one practical outcome of a lower loss level might have been to avoid the “breaking the buck” event that occurred at The Reserve Fund, which led to significant contagion in that sector after the Lehman bankruptcy.
g  Challenges in cross-border implementation

1  The likely preferred route to conferring bail-in authority would be statutory provisions in the firm’s home state conferring on the home state regulator the necessary range of powers as an extension of its resolution regime. These would include powers to cancel, write down or convert existing claims of equity and debt holders (including powers to override pre-emption or other restrictions on issuing new shares or warrants), replace management and override termination/acceleration provisions in debt and other contracts in order to preserve the firm’s value as a going concern.12

2  Because the objective is to preserve the firm as a going concern, these powers will need to be capable of operating in relation to the regulated entities within the group and the group holding company (in particular so that creditors whose claims are written down can be given equity in the group holding company) and possibly other group companies.

3  Where the regulator takes action affecting creditors’ rights under a firm’s obligations whose governing law is not the law of the firm’s home state jurisdiction (e.g. where a non-US or non-UK firm has issued debt governed by New York or English law), there will be an issue as to whether foreign courts will recognise the effectiveness of that action. One solution may be for firms to include contractual provisions in the instruments constituting those obligations making clear that the creditors’ rights are subject to the powers granted to the home state regulator under the relevant statutory provisions in the home state (so that over time the bulk of a firm’s relevant liabilities would be subject to the regime). Alternatively, states may be willing to adopt laws recognising the effectiveness of action taken under bail-in authorities in other jurisdictions (within the EU, a directive could require mutual recognition of action by other EU regulators and that taken by third country regulators whose regimes are determined to provide equivalent safeguards).

4  The resolution authority granted to the home state regulator under its law would not extend to subsidiaries in other jurisdictions (absent statutory provisions in those jurisdictions extending the home state regulator’s powers, which may conflict with local mandates). Therefore, there is the risk that the success of a bail-in could be undermined by regulatory or creditor action against those subsidiaries (e.g. to ring fence or seize local entities or assets). However, for most groups, the group holding company and the key regulated entities in the home state will be the obligors in respect of the bulk of liabilities necessary to recapitalise the group. The recapitalisation of those entities through the bail-in process should also allow the holding company sufficient flexibility to write off or convert claims on the subsidiaries and/or downstream fresh liquidity to preserve their business and to address concerns of local regulators or creditors. In addition, the subsidiaries’ regulators may also be willing to use their own powers to support the bail in process at the group level (e.g. where there are cross-default clauses). The group’s recovery and resolution plans should enable the college of regulators to identify in advance where co-operative action might be necessary to enable a bail in process to be successfully implemented.

h  Impact on capital resources and debt pricing

1  Capitalisation of most large banks typically includes a variety of instruments, including equity, preferred and hybrid capital instruments, and senior and subordinated unsecured debt. In many cases, a bail-in would need to convert only a few junior classes (e.g. subordinated debt) to recapitalise. In severe cases (such as Lehman) a firm

---

12 A possible alternative approach is to embed the resolution authority in debt instruments that are potentially subject to conversion/write down. There would be issues for the regulators as to whether they are prepared to rely solely on contractual authorities without a statutory basis, particularly where there are large number of contractual provisions in potentially different forms in a multiplicity of senior debt instruments and where the regulator is required to exercise significant discretion. In addition, the regulator is likely to need statutory powers to cancel existing shares, override pre-emption rights, stay termination rights, change management, etc.
might, however, need to allow for the capability of converting a portion of its senior unsecured debt to create sufficient capital.

2 The scale of the unsecured senior class would help provide assurance to supervisors and regulators that a bank possessed sufficient resources to handle even highly adverse scenarios via a bail-in. For example, the 20 largest US banks have approximately $3.3 trillion of non-deposit liabilities. A majority of this is comprised of senior and subordinated debt that, if converted to equity, would create a pool of potential going concern capital that far exceeds their existing tier 1 capital of approximately $0.8 trillion.

3 The cost of funding in a bail-in regime is an important practical consideration. Some believe that it might be significantly more expensive than the current regime and that it should be analysed like a form of contingent capital. Others believe that the correct analysis is based on an economic framework that considers debt subject to a bail-in regime as normal funding subject to a more economically efficient and appropriate form of resolution.

4 A robust bail-in regime could mean that bank debt would no longer trade on the premise that the government might bail it out upon insolvency. This will also affect bank spreads in some jurisdictions. Credit markets subject to a bail-in regime should trade based on economic fundamentals - namely the risk that a given bank will suffer a major capital shortfall.

5 The economic analysis of bail-in for the cost of bank capital rests primarily on probability of default / intervention and the size of loss given default. Probability of default should be largely unchanged by the possibility of a bail-in, as it is triggered by the same threshold conditions as a regulatory seizure. The loss given default comparison depends on the benchmark. The loss to senior investors from a bail-in should be smaller than a Lehman-like liquidation (roughly 20% recovery) but larger than situations where debt investors are fully protected by government support. A reliable policy of full government support would produce cheaper funding but undermines the key policy objective of ending bailouts. If government support is excluded (or even uncertain in practice), bail-in should provide a better result to investors than liquidation because of the lower loss given default.

6 Uncertainty remains over whether the overall cost impact would be somewhat negative, due to the loss of potential government support as well as market structure and transition concerns, or be flat to negative for well-run institutions, due to the economic effect cited above.

i Potential feedback effects and market discipline

1 It is important to consider how firms and markets would react to a convincing bail-in framework. Some firms may be incentivised to replace unsecured debt (subject to potential bail-in conversion) with protected, lower cost financing such as repo. While this incentive may not be significant in good times, it could grow if a firm faced a crisis and debt investors feared a bail-in.

2 This pressure could be managed via anti-arbitrage rules, but this would bring different challenges. Perhaps the simplest, most direct approach would be to require a minimum level of unsecured debt that could be accessed. The “bail-in capital” ratio could become a key systemic risk indicator.

13 Quantifying the cost of losing sovereign support can also be considered a “benchmarking” issue. If policymakers succeed in making bailouts extinct, then this issue will be removed and the only question will be around the efficiency of the methods used to resolve a troubled firm.
3 It is possible that a bail-in policy could change market behaviour for certain classes of counterparties. In particular, if certain customer and liability sectors (insured deposits, derivatives, repo) are protected, they should be less prone to flight risk if rumours about a bank’s health begin to surface. This could result in less market discipline from these markets. However, these groups have often been less valuable as a signal due to the short tenor of these instruments and because other financial elements (e.g. collateral support) often overshadow the credit view of the underlying firm.

4 In contrast, a bail-in regime could lead to the unsecured debt market being used to signal the creditworthiness of the bank. This is a good outcome as this market is more comfortable with credit analysis and better suited to provide strong market discipline.

5 Transferring losses to shareholders and creditors addresses moral hazard. Some might argue that imposing greater losses (e.g. from liquidation) might be better still, because larger losses might provide stronger incentives. We believe that the motivations for managers, equity and debt holders to work hard to avoid a bail-in are sufficiently strong. Beyond that we see no benefit from imposing higher losses on the financial system if a firm could be reorganized among private investors without taxpayer capital.

6 Bail-in avoids the need for a cumbersome restructuring of a firm’s internal organisation (for example, subsidiarisation) that other commentators have suggested as a way to deal with the potential failure of a large bank. Similarly, bail-in mitigates the need for overly conservative capital requirements that could affect economic growth, which are driven by the same objectives as bail-in, namely, avoiding bailouts.

Summary

1 A bail-in could increase going concern bank capital by a large multiple and would give regulators an important new tool in a future crisis.

2 Bail-in protects depositors, transaction payments and key customer activities, which should materially lower the risk of runs and reduce a source of systemic risk.

3 While bail-in does haircut certain investors, they are likely to end up with a better economic outcome.

4 Bail-in reduces systemic risk by avoiding a potentially costly and damaging liquidation outcome. By reducing the cost of big bank failure and improving certainty, it reduces the risk and impact of contagion.

5 Bail-in could be used to help address the challenging issue of cross-border resolution. It creates new capital that could be used to recapitalise subsidiaries and create mutual incentives for a globally constructive solution.
### Summary Terms of Lloyds and Rabobank Contingent Capital Notes

<table>
<thead>
<tr>
<th></th>
<th>LBG ECNs</th>
<th>Rabobank SCNs</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Subordination:</strong></td>
<td>In a winding-up will rank junior to Senior Creditors and senior to UT2 and Tier 1 capital and all share capital <em>Pari passu</em> with LT2 capital</td>
<td>In a winding-up will rank senior to Tier 2 and Tier 1 capital and all share capital <em>Pari passu</em> with other senior unsecured obligations</td>
</tr>
<tr>
<td><strong>Maturity:</strong></td>
<td>Dated, bullet, minimum 10 years</td>
<td>Dated, bullet, 10 years</td>
</tr>
<tr>
<td><strong>Early redemption options:</strong></td>
<td>Tax and capital disqualification calls</td>
<td>Tax call</td>
</tr>
<tr>
<td><strong>Coupon deferral:</strong></td>
<td>None</td>
<td>None</td>
</tr>
<tr>
<td><strong>Issuer conversion option:</strong></td>
<td>None</td>
<td>None</td>
</tr>
<tr>
<td><strong>Mandatory conversion / write-down:</strong></td>
<td>Mandatory conversion into fixed number of ordinary shares of LGB upon breach of Trigger Event Conversion ratio is based on the share price at issue</td>
<td>Mandatory write-down of original principal amount to 25% of par if Trigger Event occurs Automatic redemption at 25% of original principal after mandatory write-down</td>
</tr>
<tr>
<td><strong>Investor conversion option:</strong></td>
<td>None</td>
<td>None</td>
</tr>
<tr>
<td><strong>Trigger event:</strong></td>
<td>Latest published consolidated Core Tier 1 ratio falls below 5%</td>
<td>Equity Capital Ratio is less than 7% as certified by two Executive Board members on any two successive observation dates approximately 23 business days apart Equity Capital Ratio means Equity Capital / RWA of Rabobank on a consolidated basis</td>
</tr>
<tr>
<td><strong>Regulatory treatment:</strong></td>
<td>LT2 for Pillar 1 and Pillar 2, and upon conversion as Core Tier 1 Core Tier 1 under FSA’s stress test</td>
<td>None stated</td>
</tr>
<tr>
<td><strong>Ratings:</strong></td>
<td>Ba2 / BB / BB</td>
<td>Unrated</td>
</tr>
</tbody>
</table>

*Note: Moody’s have subsequently stated that they will not rate subsequent instruments given regulatory uncertainty re trigger linked to regulatory capital*

---

1 Core Tier 1 means core tier one capital as defined by the FSA as in effect and applied (as supplemented by any published statement or guidance given by the FSA) as at 1 May 2009
2 Equity Capital means the aggregate Euro amount of Member Certificates (and such successor or other instruments representing capital paid up or contributed to the Rabobank Group by members) and retained earnings of the Rabobank Group at such time calculated by the Issuer on a consolidated basis in accordance with the accounting standards applicable to the Rabobank Group at such time

**Source:** Offering Circulars
### Triggers for Use of Resolution Powers under the UK Banking Act, US Dodd-Frank Act and UK Insolvency Act

<table>
<thead>
<tr>
<th>Resolution Powers</th>
<th>Triggers</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>UK</strong>&lt;br&gt;Use of stabilisation powers under the UK Banking Act 2009 (the “UK Banking Act”)</td>
<td>Under Section 7 of the Banking Act, a stabilisation power (i.e. including a transfer to a private sector purchaser, bridge bank or to temporary public sector ownership) may be exercised in respect of a bank only if the UK Financial Services Authority (“FSA”) is satisfied that the following two conditions are met:&lt;br&gt;&lt;br&gt;<strong>Condition 1</strong> is that the bank is failing, or is likely to fail, to satisfy the threshold conditions (within the meaning of section 41(1) of the Financial Services and Markets Act 2000 (“FSMA”) (permission to carry on regulated activities)).&lt;br&gt;&lt;br&gt;<strong>Condition 2</strong> is that, having regard to timing and other relevant circumstances, it is not reasonably likely that (ignoring the stabilisation powers) action will be taken by or in respect of the bank that will enable the bank to satisfy the threshold conditions.&lt;br&gt;&lt;br&gt;Section 7(4) specifies that the FSA shall treat Conditions 1 and 2 as met if satisfied that they would be met but for financial assistance provided by the Treasury or the Bank of England (disregarding ordinary market assistance offered by the Bank on its usual terms).</td>
</tr>
<tr>
<td><strong>US</strong>&lt;br&gt;Systemic risk determination under Section 203 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”)</td>
<td>Under Section 203(a)(4) of the Dodd-Frank Act, a financial company shall be considered to be “in default or in danger of default” (and therefore subject to the orderly liquidation provisions of the Act) if, as determined by the Treasury Secretary in accordance with the Act:&lt;br&gt;&lt;br&gt;(a) a case has been, or likely will promptly be, commenced with respect to the financial company under the Bankruptcy Code;&lt;br&gt;&lt;br&gt;(b) the financial company has incurred, or is likely to incur, losses that will deplete all or substantially all of its capital, and there is no reasonable prospect for the company to avoid such depletion;&lt;br&gt;&lt;br&gt;(c) the assets of the financial company are, or are likely to be, less than its obligations to creditors and others; or&lt;br&gt;&lt;br&gt;(d) the financial company is, or is likely to be, unable to pay its obligations (other than those subject to a bona fide dispute) in the normal course of business.</td>
</tr>
<tr>
<td><strong>Switzerland</strong>&lt;br&gt;Condition to taking action on a failing bank by Swiss authorities</td>
<td>FNMA can decree the following “preventative measures”, restructuring, or liquidation if “a justified concern exist that a bank is over-indebted or has serious liquidity concerns or that the bank no longer fulfils the capital-adequacy provisions after expiry of a deadline set by FNMA”. Preventative measures may be decreed in isolation or in conjunction with a restructuring or liquidation.&lt;br&gt;&lt;br&gt;A bank is “deemed to be overindebted as soon as the valuation of its assets is such as to raise doubts about its ability to meet the claims of its creditors.”&lt;br&gt;&lt;br&gt;Timing&lt;br&gt;&lt;br&gt;“Early intervention”: FNMA “steps in as soon as a bank is unable to comply with the capital-adequacy requirements for an extended period or experiences liquidity problems, or if there is other indications of impending insolvency. No formal evidence of overindebtedness or inability to meet payment obligations is required before restructuring or liquidation proceedings are initiated.”</td>
</tr>
<tr>
<td><strong>UK Insolvency Law</strong>&lt;br&gt;Administration order under the UK Insolvency Act 1986 (as amended by the Enterprise Act 2002) (the “Insolvency Act”)</td>
<td>Under paragraph 11 of Schedule B1 of the Insolvency Act, a court may make an administration order in relation to a company only if satisfied -&lt;br&gt;&lt;br&gt;(a) that the company is or is likely to become unable to pay its debts, and&lt;br&gt;&lt;br&gt;(b) that the administration order is reasonably likely to achieve the purpose of administration.&lt;br&gt;&lt;br&gt;Where the company in question is a regulated entity, the FSA’s consent to the appointment of the administrator is required under Section 362A of FSMA.</td>
</tr>
</tbody>
</table>
AFME (Association for Financial Markets in Europe) promotes fair, orderly, and efficient European wholesale capital markets and provides leadership in advancing the interests of all market participants.

AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants.


AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76.

**Contacts**
The principal AFME policy experts for the topics covered in this report are:

**Financial stability and systemic risk:**
Mark Hart, mark.hart@afme.eu

**Corporate governance:**
William Ferrari, william.ferrari@afme.eu

**Remuneration:**
Lorraine Charlton, lorraine.charlton@afme.eu

**Financial resources:**
Peter Beales, peter.beales@afme.eu
Anita Millar, anita.millar@afme.eu
Diane Hilleard, diane.hilleard@afme.eu

**Market infrastructure:**
Folake Shasanya (OTC markets), folake.shasanya@afme.eu
Sander Schol (government bond markets), sander.schol@afme.eu
Christian Krohn (post-trade issues), christian.krohn@afme.eu

**Resolution and fast-track capitalisation:**
Gilbey Strub, gilbey.strub@afme.eu